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ABSTRACT

The congressional hearing report scrutinized the role of banks, guarantee agencies, student loan secondary markets, and loan servicers in the operation of federal student aid programs. Program weaknesses which have contributed towards to abuse and fraudulent practices of federally backed student loans were identified. Witnesses included officials from major banks, guarantee agencies, loan services and student aid commissions and their testimonies focused on matters such as: guarantee agency solvency, the economics of student lending, institutional default rates, loan defaults, mismanagement of programs, and program reform, among other issues. (LPT)

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S. Hrg. 101-659, Pt. 3

ABUSES IN FEDERAL STUDENT AID PROGRAMS

HEARINGS

BEFORE THE

PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

PART 3

LENDERS, GUARANTEE AGENCIES, LOAN SERVICERS,
AND THE SECONDARY MARKET

SEPTEMBER 25, 26, 1990

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ABUSES IN FEDERAL STUDENT AID PROGRAMS

TUESDAY, SEPTEMBER 25, 1990

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee convened, pursuant to notice, at 10:08 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Sam Nunn, Chairman of the Subcommittee, presiding.

Present: Senators Nunn and Roth.

Staff Present: Eleanore J. Hill, Chief Counsel; John F. Sopko, Deputy Chief Counsel; Mary D. Robertson, Chief Clerk; Alan Edelman, Counsel; David Buckley, Chief Investigator; Harold B. Lippman, Investigator; Grace McPhearson, Investigator; Cynthia Comstock, Staff Assistant; Mariea Sweeney, Staff Assistant; Daniel F. Rinzel, Minority Chief Counsel; Carla Martin, Assistant Chief Clerk to Minority; Blaine Phillips, Staff Assistant to Minority; Jack Mitchell [Senator Levin]; Ellice Halpren-Barnes [Senator Stevens]; and Lois Haas [Senator Wilson].

[Letter of authority follows:]

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

Pursuant to Rule 5 of the Rules of Procedure of the Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, permission is hereby granted for the Chairman, or any Member of the Subcommittee as designated by the Chairman, to conduct open and/or executive session hearings without a quorum of two members for the administration of oaths and the taking of testimony in connection with hearings on Abuses in Federal Student Aid Programs (Part 3) to be held on September 25 and 26, 1990.

SAM NUNN,
Chairman.
WILLIAM V. ROTH, Jr.,
Ranking Minority Member.

OPENING STATEMENT OF SENATOR NUNN

Senator NUNN. The Subcommittee will come to order.

This morning the Permanent Subcommittee on Investigations continues its examination of weaknesses in the Federal student aid programs. In past hearings this year the Subcommittee received testimony which paints a bleak picture of the fiscal integrity of the Federal guaranteed student loan program. At this point in our investigation we have yet to hear of even a single part of the student loan program that is working efficiently and effectively. The testimony has been so discouraging that one can wonder if even immediate and concentrated reforms can at this stage salvage these programs.

The Subcommittee has heard, for example, that unscrupulous schools create educational courses of dubious worth, use commissioned salespeople to prey on unsuspecting students, and then easily amass millions of dollars of profit in Federal funds at the ultimate expense of the taxpayer. We have heard a convicted school owner testify how he was able, with apparently little effort, to obtain over $400,000 in student loan funds for fictitious students that he had invented and run through the system.

Just 2 weeks ago the Subcommittee examined the method by which the Department of Education screens schools for participation in the student aid program. Again we heard about the extent to which program weaknesses have effectively crippled the State licensing and accreditation processes. Despite these problems, we were told that the Department of Education continues to rely almost exclusively on these processes, adding little more than a rubber stamp seal of approval for schools to participate.

Today the Subcommittee turns its attention to the financial players in the student loan program. Banks, guarantee agencies, student loan secondary markets and loan servicing operations all play an integral part in providing loans to students and later in collecting these loans. Yet, despite the billions of dollars involved, today and tomorrow we will hear that serious program weaknesses extend to these levels of program participation as well.

These weaknesses involving some schools, students, lenders and loan services, coupled with lax oversight and minimal enforcement of laws and regulations, have left these programs open to abuse and outright fraud. Program officials and the Inspector General at the Department of Education find themselves scrambling to tackle the resulting mess. The gravity of all these problems was underscored this July when the Nation received ominous news regarding the single largest guarantor of federally backed student loans, the Higher Education Assistance Foundation, known as HEAF. The foundation, a nonprofit corporation based in Kansas, has sold its guarantee on what now amounts to approximately $10 billion of student loans. Over time most of those loans were made to students of for-profit trade schools, who as a group represent the highest defaulters on taxpayer-backed student loans. Burdened by rising default costs, the foundation, whose president will testify this morning, is now facing serious financial difficulties.

Today and tomorrow the Subcommittee will also examine what many believe is the largest single fiasco involving the student loan program, namely the collapse of the First Independent Trust Company of Sacramento, California, known as FITCO. FITCO's questionable activities and eventual failure have generated immeasurable problems for guarantee agencies like HEAF, other banks, investors here and abroad, and the program as a whole. FITCO's secondary market, the California Student Loan Finance Corporation, was the Nation's second leading holder of student loans at one time, second only to Sallie Mae. United Education and Software, UES, a corporation which owned dozens of proprietary schools, was responsible for servicing these loans. Today we will hear that computer programs allegedly written to falsify information regarding loans to the FITCO portfolio have now been discovered after the fact at UES. Again, we have before us a situation where abuses and mistakes by program participants apparently went undetected, eventually resulting in hundreds of millions of dollars in losses.

Today and tomorrow we will have the opportunity to try and determine how that happened and what, if anything, can be done to prevent it from happening again. To assist us in that effort, our staff will present this morning a summary of their investigation. Among other things, they found that as student loan volume has skyrocketed, falsification of loan origination and collection information has occurred and often gone undetected for long periods of time at both loan servicing as well as lender organizations. The skyrocketing loan volume and default rates, coupled with growing problems of waste, fraud and abuse, have begun to adversely affect not only HEAF but other guarantee agencies as well. The Department of Education oversight of lenders, guarantee agencies, loan services, and secondary markets is poor and its enforcement efforts are poorer still. And finally, in the case of FITCO, despite numerous adverse findings of abuse and mismanagement by various regulators, FITCO was nevertheless allowed to continue in the student loan program, ultimately becoming one of the Nation's largest lenders prior to its financial collapse and liquidation in 1989.

Again, Senator Roth, I would like to thank you as our Ranking Minority Member for your continued support in this investigation and for the splendid cooperation of your staff. I know you share my concerns about the future of this program and share my concerns about how we can develop legislative remedies where appropriate, and certainly better management where appropriate, in correcting these problems.

Senator Roth.

OPENING STATEMENT OF SENATOR ROTH

Senator ROTH. Mr.Chairman, over the past several months, these hearings have given us a chance to examine a well-intentioned program that is unfortunately plagued by waste and abuse. We have witnessed the practices of unscrupulous operators who set up shoddy schools with the sole purpose of recruiting the largest volume of students possible in order to obtain the largest number of student loans possible. These operators rely on the money that they receive from Federal student—aid which certainly was not the intention of the student loan program. We have also heard about the lax accreditation practices that too often give the green light for these unscrupulous school operators to sup at the Federal trough.

In recent months we have seen the problems in the student loan program come to a boil. HEAF, the Higher Education Assistance Foundation, one of the country's largest guarantee agencies for student loans, has sent up a financial distress signal. These problems were allegedly due to a chain reaction caused by shady lenders. The result was that HEAF ended up having an unmanageable amount of bad loans in its portfolio and is struggling to honor its guarantees.

Mr. Chairman, I know there has been some effort in Congress, particularly in the Senate, as well as the Administration, to reform the student loan program during the past few years. But it seems clear to me that the schemes that have been so effectively brought to light by your staff in the last few hearings demonstrate without doubt that these efforts are indeed far too modest. The doors to the Federal treasury, I am afraid, have been left open and unguarded. Congress cannot afford to delay any longer in making comprehensive reforms. Knowledgeable experts predict that the dollar amount of student loan defaults is going to continue to increase rapidly if nothing further is done to reform the program. If something is not done about the proprietary school scandals that we have heard so much about in these hearings, I fear—greatly fear, Mr. Chairman—that the integrity of the entire student loan program could be at stake.

I don't accept the arguments made by some witnesses at our last hearing that everything is under control and that the necessary changes have already been made. I think that view clearly represents the ostrich approach. When an ostrich sticks his head in the sand he may find it temporarily comforting, but he leaves a lot of posterior exposed, and I just don't think the taxpayers like that kind of exposure, and I don't either.

Thank you, Mr. Chairman.

Senator NUNN. Thank you very much, Senator Roth.

Our first witness this morning is representing the Consumer Bankers Association. Mr. William L. Banks is a Vice President of the Student Loan Division of Chemical Bank in New York. The Subcommittee has asked Consumer Bankers Association to present the lenders' perspective on the guaranteed student loan program.

After we hear from Mr. Banks, we will have a panel of our staff, and then we will have a second panel following that.

Mr. Banks, we swear in all the witnesses before our Subcommittee. So if you will stand, I will give you the oath here. Do you swear the testimony you give before the Subcommittee will be the truth, the whole truth, and nothing but the truth so help you God?

Mr. BANKS. Yes, Mr. Chairman.

Senator NUNN. We appreciate you being here this morning, Mr. Banks.

TESTIMONY OF WILLIAM L. BANKS, VICE PRESIDENT, STUDENT LOAN DIVISION, CHEMICAL BANK, REPRESENTING CONSUMER BANKERS ASSOCIATION

Mr. BANKS. Good morning. Mr. Chairman, with your permission I have a prepared statement for the record.[1] However, I will be reading a shortened version based on available time.

Mr. Chairman, members of the Permanent Subcommittee on Investigations, I am William Banks, Vice President of Chemical Bank. I am responsible for the product management of Chemical Bank's student loan business, and serve as a member of the Education Funding Committee of the Consumer Bankers Association. My testimony today reflects the views of the CBA Education Funding

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[1] See p. 135.

Committee and will focus on five principal areas. First, the history of the Stafford Student Loan program, the economics of student lending, defaults in the student loan program, guarantee agency solvency, and fifth, recommendations to simplify program operations.

In our view, the student loan program is an impressive example of a successful partnership between the Federal Government and the private sector. Unfortunately, however, that success has been blemished by an increasing level of defaults in the program. In fiscal year 1990, the Department of Education expects to pay more than $2.3 billion in defaults. Focusing on the default problem however, it is important to note that more than 90 percent of all student loans originated are eventually repaid.

Since 1965, Congressional oversight and revision of the guaranteed student loan programs has been constant. For the past 8 years, at least one set of amendments has been enacted annually. Since 1965, more than 30 separate amendments affecting the program have been enacted. I will not recount them here, but will note that the original role of the student loan program as a means of providing liquidity to middle income students and their families has been changed to one of providing basic assistance to low-income families. This evolution in the program—the result of budget pressures, differing political philosophies, and other factors—has resulted in a situation where a growing level of delinquencies and defaults logically follows. The elimination of middle income students from eligibility for GSLs in the 1986 amendments further concentrated receipt of Federal student aid with low-income borrowers.

The changing profile of the student loan borrower parallels a similar increase in the number of proprietary schools eligible for participation in Federal student financial aid programs. Since 1972, students attending proprietary schools have received aid under the GSL, Pell Grant, and several campus-based programs. In 1980, students who had not completed high school but demonstrated an ability to benefit from post-secondary education also became eligible to receive Federal assistance.

Most proprietary schools serve a much higher concentration of low-income students than do other sectors of higher education. The increase in the number of students attending proprietary schools results in an increase in the percent of low-income students receiving aid under Title IV programs. Put another way, since 1981 the administrative task for lenders attempting to collect payments from the borrower has increased. It must also be noted that loans to students at short-term proprietary schools are smaller, go into repayment more quickly, and because of the poorer financial circumstances of these borrowers, are more likely to enter default.

Finally, in addition to facing these higher intrinsic servicing costs and a decline in the likelihood of loan repayment, the program has become more complex and, in the view of most lenders, over-regulated. With each amendment and the subsequent regulations issued by the Department of Education, Federal micromanagement has increased. Lenders attempting to comply with these requirements have found that, first, over-regulation has led to a proliferation of rules, standards, and administrative requirements which are needlessly complex and create opportunities for inadvertent violations that can jeopardize insurance coverage.

Second, monitoring and implementing these standards is a difficult task which a small to medium size lender is ill advised to even attempt. Third, when program changes are enacted, timely guidance must be forthcoming to lenders and other program participants from the Department of Education.

In making these comments, we want to be sure there is no misunderstanding. Lenders support diligent program oversight by the Congress and the Department of Education. What CBA members object to are cumbersome requirements which do not contribute to improved collection.

I would like to take a few minutes and share with you how the evolution of the program has affected the returns lenders are able to achieve through participation.

Senator **Nunn**. Mr. Banks, it would help us if you would send a list to us—and maybe you can attach it to your testimony—of those practices that you believe do not contribute to proper management. In other words, the requirements that you think are excess. Because we have heard time after time, example after example, of under-regulation, and it would be interesting to us to hear where the over-regulation is. And it may be that we have a combination, the worst of all worlds; an awful lot of rules, laws, and regulations and nobody to enforce them.

But it is obvious that those who don't want to pay attention to them are able to get away with not paying attention to them for a long time. Perhaps conscientious lenders that try to live with them and do them the correct way are caught in the vise, but we just had example after example. For instance, in California there are 8 program personnel overseeing 14 States, and that includes 11 guarantee agencies, 14 secondary markets, and 729 lenders. I don't see how anybody in that group could say that they are given too much oversight. Maybe they are generating a lot of paperwork. In Georgia there are 5 program personnel reviewing 8 States, which include 1,200 lenders. So I really have a hard time understanding how there could be over-regulation with that few people.

Maybe you could explain that to me? I mean, the most they could do is fly over, it seems to me.

Mr. **Banks**. Mr. Chairman, I would suggest we will submit to you a list of items that we feel are over-regulation, which in some areas would be separate from the audits of lenders. The area of over-regulations we look at, there are "time is of the essence" requirements of a lender that has to be done 30, 60, 90 days, which to a normal collection area of the bank don't mean that a loan can be collected or can't be collected. And this is the thing I believe that lenders are struggling with, some of the "time is of the essence" processing required. Again, I do support the strong audit of lenders and secondary markets.

Senator **Nunn**. Well, I guess what I am asking is, are you making a distinction between what is theoretically required and what is actually done by regulation? Are you saying that people are coming around and harassing you in banks and giving you a lot of problems and so forth? Because I don't know how they do it. I mean, you have got 14 people overseeing 1,200 lenders in California. You have got five people reviewing eight States and 1,200 lenders. I mean, it is just impossible for them to be in there harassing anybody. Now, maybe the paperwork does, but I am just trying to get what you are saying.

Mr. BANKS. From the point of audits, every claim a lender sends into a guarantor in the States that we deal with, I believe those guarantors are reviewing every claim to make sure the phone calls and letters are done. And to that extent, every claim that is paid to Chemical Bank has been, in my mind, fully audited by a State agency.

Senator NUNN. Which States do you operate in?

Mr. BANKS. New York, Connecticut, New Jersey, Ohio, Colorado, Texas, and we deal with a USAF guarantor.

Senator NUNN. But you are speaking for lenders that are all over the country, right, in all of these regions?

Mr. BANKS. Many banks have merged over the last few years, so they are in multiple States today.

Senator NUNN. Okay. Go ahead.

Mr. BANKS. I would like to take a few minutes and share with you how the evolution of the program has affected the returns lenders are able to achieve through participation. Through this information, I hope to convey to you why many smaller lenders are choosing to restrict or eliminate their participation in the program.

The principal findings of the CBA analysis were: higher default rates results in lower yields on loans; smaller loans result in lower yield; shorter in-school periods result in lower yield.

We have prepared three charts, Mr. Chairman.[1] The first chart presents a 4-year college loan. This is the most desirable loan to a lender. And on this chart, we depict the return on assets for a particular loan. CBA's 1989 survey stated that the minimum yield that lenders say they need on consumer loans is around 60 basis points after tax, which equates to a 90 to 100 basis points, or about 1 percent net earnings before tax. This is the minimum yield that lenders are looking for. Again, a 4-year college loan with a long in-school period, multiple loans for long term, provide adequate yields to lenders.

A high default proprietary school, a school with a 50 percent default rate, basically has everything going against it from an economic point of view. The in-school period is short, borrowers don't take multiple loans, and based on the 50 percent default rate, most of those loans purge off approximately in 22 months, and the lender has to go through all the expense of the collection efforts, which are extremely costly.

The community college loan is closer again to the 4-year college loan, and again, we are representing around a 20 percent default rate in our computer models we ran on this. Again, the loans are heavily geared towards loan size, the larger the loan, the larger the yield to lenders.

As I noted previously, the issue of defaults has emerged as the single most important student loan issue for the past several years. Not only has this issue risen because of the cost of defaults, but high default rates have also been an issue in the well publicized financial problems of the Higher Education Assistance Foundation.

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[1] The charts referred to follow Mr. Banks' prepared statement.

Any discussion of defaults must begin with an understanding of that with a program of this nature a certain level of defaults is inevitable. Guaranteed student loans are made only to low-income people with no up-front credit criteria. During the past 4 years, Congress has enacted significant default reduction legislation, and the Department of Education has issued its default reduction initiative regulations. Beneficial effects are just now being reflected if default experience under the program and will escalate in the future.

Effective collection efforts are as important to students as they are to institutions, guarantors, and lenders. Low-income borrowers who successfully complete their education, find satisfying employment, and pay off their debts are enjoying the educational access that student aid programs were meant to provide. Students who drop out of school or fail to find employment and find themselves burned by educational debts they are unable to pay, are victims of a well meaning but ineffective public policy.

Surveyed lenders indicate that 5 program modifications implemented since 1986 have been particularly effective in addressing the problem of defaults. These include, first, multiple disbursements. This provision requires lenders to make loans available to students in two or more equal payments, plus many defaulters are students who enroll but quickly drop out of school. Multiple disbursement reduces by at least 50 percent the size of the loan they must repay.

Institutional eligibility SLS cutoff based on 30 percent or higher default rate. The enactment of this provision by Congress quickly eliminated overuse of this loan program by low-income students attending short-term programs. The Government Accounting Office recently announced that in the first 6 months of 1990, borrowing in the SLS program dropped by 46 percent. More importantly, it sent a message to schools that Congress won't tolerate schools with high default rates.

Required credit bureau reporting. Students quickly understand that this is the key to their future credit. IRS income tax offset. As of 1989, in excess of $500 million has been returned to the U.S. Treasury through this provision. Fifth, the Department of Education default reduction initiative regulations authorizing limitation, suspension, and termination procedures against high default rate schools based on institutional default rates.

Following the enactment of the 1986 amendments to the Higher Education Act, lenders themselves began examining more quickly the default experience of participating institutions. At a speech before CBA in Washington, D.C., in November 1988, Charles Kolb, then Deputy Under Secretary of the Department of Education, strongly urged lenders to police their schools. This directive was taken to heart. Many banks now limit lending to only schools with default rates below 25 percent, and some have cut off lending to proprietary schools entirely.

The most common profile of a student loan defaulter is a low-income borrower who left school without receiving a degree or certificate. These students are individuals who instead of profiting from higher education find themselves in worse financial circumstances for having received a student loan.

The Stafford Student Loan program, as it now operates, makes loans available to students and requires that they repay them even if they never finish school. In CBA's view, a major part of default reduction must be directed at reducing negative educational outcomes, including students dropping out without completing a chosen course of study, or students unable to find employment in career fields for which they have become certified.

Members of the Senate and the House are now in conference on S. 695, the President's Excellence in Education Act. The Senate version of this legislation contains additional measures to reduce student loan defaults. Senator Claiborne Pell, the Chairman of the Senate Subcommittee on Education, Arts and Humanities, is to be commended for this legislation and his continuing persistence in bringing default reduction initiatives before the Congress.

The recent financial problems at HEAF are another area of major concern to lenders participating in the program. CBA is pleased that Secretary Cavazos is expected to announce a resolution to this problem that is in the best interest of both the Federal Government and the students served by the program. Though the immediate crisis at HEAF will soon be resolved, the uncertainties raised by this problem continue to be felt in the student loan marketplace. Every lender managing a significant student loan portfolio has had reason to review and reevaluate its current financial exposure and continued participation in these programs. CBA believes Congress needs to address this problem in the next reauthorization.

I will not review all of the recommendations for changes to the Higher Education Act that CBA anticipates pursuing in the reauthorization process. Instead, I would like to focus on a single area, program simplification. Program simplification represents an opportunity to reduce the cost of the program while at the same time making it work more effectively for the intended beneficiaries, students at post-secondary institutions.

In addition to addressing the problem of guarantee agency solvency and the complexity of services requirements, CBA has also recommended that Congress consider the following modifications. Deferment simplification. There are presently 15 separate deferment categories available to borrowers. CBA recommends all deferments be repealed and replaced with two deferments, one for in-school status and the other for financial hardship.

Secondly, forms and requirement consistency between guarantee agencies. CBA believes Congress should explore means of discouraging unnecessary difference and actively promoting uniformity in forms, procedures, and other program requirements.

In closing, CBA would like to emphasize that notwithstanding the well publicized problems facing the program, we believe the Stafford loan program is fundamentally sound. We support efforts to date by the Department and the Congress to improve loan collection while at the same time protecting the rights of student borrowers. CBA believes that morals and ethics play an important role in the student loan program, and we categorically oppose fraudulent practices which take advantage of student borrowers and oppose the public trust. Hopefully, the Congress, the Administration and others can work together in reauthorization to address the default problem more completely, close opportunities for fraud and abuse, and make the program work more efficiently for students.

Thank you for the opportunity to testify here today. I would be happy to respond to any questions you may have.

Senator **Nunn**. Thank you very much, Mr. Banks.

How many different lenders does your association represent?

Mr. **Banks**. We represent about 800 student lenders, which represents around 74 percent of all student loans originated.

Senator **Nunn**. How do you get to be a member of your association?

Mr. **Banks**. It is a trade association that basically includes commercial banks, credit unions and savings banks.

Senator **Nunn**. But they are primarily members of those who make student loans?

Mr. **Banks**. It represents all phases of consumer lending.

Senator **Nunn**. So it is much broader than students?

Mr. **Banks**. Yes.

Senator **Nunn**. Would the Bank of Horton be a member of your association?

Mr. **Banks**. They joined I believe about 1½ or 2 years ago.

Senator **Nunn**. How about the First Independent Trust Company?

Mr. **Banks**. I really didn't check the list, I am not sure on that. No, we don't believe they are a member.

Senator **Nunn**. Mr. Banks, I am told, and your statement indicates, that you are having difficulty with the due diligence requirements for collection of delinquent student loans; is that right?

Mr. **Banks**. That's correct.

Senator **Nunn**. How much more does the Department of Education require of the student loan services than you would have to perform on a car loan or say a home mortgage that was not guaranteed by the Federal Government?

Mr. **Banks**. I believe that the main difference between the two is that on a student loan in 1986 the new regulations that came out for I believe the 1981 reauthorization, "buckets" were created, which basically meant activities had to happen in 30, 60, 90, 120 days periods of delinquency. As a guideline it is a good idea that a lender performs those items. However, on an automobile loan, a home equity, or credit card, you still can collect on a loan even if you didn't complete an activity in a bucket. And based on this program where there are so many participants—for instance, schools have to send out-of-school notices to guarantors in various forms, whether it is magnetic tape or paper-based on all these items coming in, there is a litany of items that a lender has to perform within 10 days or 30 days, which is very difficult in an unautomated process.

Senator **Nunn**. Do you believe lenders should be required to practice due diligence in making a loan?

Mr. **Banks**. The main program that—on the parent loans specifically where a parent does have credit, we do check the credit of the parent. But in all other cases the student normally just does not have a credit history, and other than a default rate of the school—

and again, we are not educators—the default rate of the school to me seems has been a predictable item as to potentially some of the problems in the program.

Senator NUNN. In your normal lending you would take collateral, right, and in these loans you don't have collateral beyond the Federal guarantee, which is the ultimate collateral, but I guess that in a place—let's say you got a home mortgage loan, you don't need to exercise the same kind of diligence there as you do with an uncollateralized loan, do you?

Mr. BANKS. Correct. You always have the option to go against the house or the automobile. On a credit card or a personal loan, again, you don't have collateral in those cases.

Senator NUNN. Do you think that lenders should run credit checks on student loan borrowers to see if the borrower is already in default or has some other bad credit history?

Mr. BANKS. In general, I have to believe that a 80 to 90 percent of the students don't have a credit history, so it would be a cumbersome requirement to have to find a few older students that actually do have a credit history.

Senator NUNN. You think it would be more trouble than it is worth?

Mr. BANKS. It would be very expensive.

Senator NUNN. Of course, if you have got a 100 percent guarantee, it doesn't really affect you. But from the Government point of view, what about the Government? If it was your money, would you be running credit?

Mr. BANKS. We wouldn't make a loan without running credit.

Senator NUNN. But from the Government point of view you think it is too much trouble.

Mr. BANKS. From the Government's point of view, a borrower that has a negative history, it would be in the best interest, where you have a 27-year old student, to look at that.

Senator NUNN. Well, I am just saying if you were placing yourself in the shoes of the taxpayer, would you as a taxpayer think that all these loans should have some kind of at least preliminary credit so that if it was someone who had already had a lot of credit difficulty, they could be turned down. Do you think that would be prudent?

Mr. BANKS. I don't believe it is necessary. I believe that the correlation is much higher on taking a look at the schools and the outcomes of the education. I think, from reducing the taxpayers' burden, I think that is much more important, because such a small portion of these students actually have a credit history.

Senator NUNN. So looking at the school itself would pay off more you think?

Mr. BANKS. Correct.

Senator NUNN. Should the lenders assume more of the risk in this program, or would that just kill the program?

Mr. BANKS. I believe it would kill the program because, except for the 4-year colleges, if you just laid what has been suggested in the Congress—10 percent risk sharing—the penalty at a 4-year college with a 10 percent default rate, the penalty would be about 20 basis points, 18 basis points, where in that trade school with a 50 percent default rate the penalties are about 1.7 percent. So it is really regressive penalty, and for that reason lending would totally dry up for community colleges and trade schools.

Senator NUNN. In other words, the lenders wouldn't participate without full guarantee?

Mr. BANKS. Correct.

Senator NUNN. Even if it was 10 percent risk sharing, they wouldn't?

Mr. BANKS. For instance, the Small Business Administration loans, the charge-offs are 2 to 3 percent I understand in that program and it can be managed, but a program where by nature you are going to have default rates of 5 to 20 percent, the economics don't work out.

Senator NUNN. What kind of profit would you make in a student loan that is repaid, in other words one there is no problem in?

Mr. BANKS. For instance, the 4-year college student at a school with a 10 percent default rate, the life of the loan return is about 1.2 percent, and a lender would be happy to have that loan on their books.

Senator NUNN. Give us an example of how much money you are talking about. Let's say—what would make sense? A thousand dollar loan, what would the profit?

Mr. BANKS. Well, the internal rate of return, which basically reflects the annual profit—and the economics of this program is the lender makes a lot more money in the in-school portion than they do on the repayment portion, because there is a lot more operational work that has to be done—but on an average they would be making—if it is $1,000, they would be making about $12 a year, if you looked at a straight line.

Senator NUNN. How much does it cost to service a loan that doesn't go delinquent? What is the cost involved? Any example you think makes sense, just sort of give us a hypothetical here.

Mr. BANKS. Well, for instance, in the models that we ran on this, an in-school loan we were showing cost somewhere around 70 cents per month per loan, a repayment loan closer is $2 per month per loan, where a collection account is around $13 per month per loan while they are delinquent.

Senator NUNN. Do you believe that lenders should be required to visit schools with whom they do student loan business before originating loans to students in that school? In other words, if there is a new school that pops up in an application where they are going to take the money, do you think that lenders should be required to go out and have some review of the school itself?

Mr. BANKS. Personally, my staff, I don't feel confident that they would be able to evaluate one school from another.

Senator NUNN. So that it wouldn't be very meaningful even if you did it? You just don't have that kind of expertise?

Mr. BANKS. Correct.

Senator NUNN. You have cited the IRS income tax offset as an improvement in efforts to collect delinquent student loans, correct?

Mr. BANKS. Correct.

Senator NUNN. As we understand it, that program is, number one, voluntary, and number 2, that offset takes place only after a guarantee agency has already been reimbursed by the Federal Government; is that right?

Mr. **Banks**. I believe so, yes.

Senator **Nunn**. Would you recommend that the offset effort be required prior to reimbursement by the Federal Government?

Mr. **Banks**. I am not real certain of the mechanics. I am not sure I could give you a good answer.

Senator **Nunn**. Should that be voluntary?

Mr. **Banks**. It seems like it has been successful and it works, and I think the guarantor agencies and the Department of Education should work in the Congress to make it work and make it done in some fashion or form, because it seems to be working.

Senator **Nunn**. You wouldn't object to it being made mandatory?

Mr. **Banks**. Not from a lender's point of view, it really doesn't affect us.

Senator **Nunn**. When you talk about too much Federal micromanagement on lenders in the student loan program, are you talking about the Department of Education now, or are you talking about guarantee agencies? Who is micromanaging, because we haven't been able to find them?

Mr. **Banks**. I guess the problem, or the concern I have in this program, is the fact that the Department of Ed will issue their regulations 5 years after the legislation, or a "Dear Colleague" may come out a year after legislation.

Senator **Nunn**. That wouldn't be micromanaging, that is just very bad management, isn't it?

Mr. **Banks**. It is slow management.

Senator **Nunn**. That is almost the opposite of micromanagement, isn't it?

Mr. **Banks**. Well, I think it leads into the micromanagement where eventually they put their regulations out and then 45 or 50 guarantors interpret them as they see fit. You have some complex regulations that become more complex and sometimes misunderstood.

Senator **Nunn**. Wouldn't it be better to say "incompetent management"? Wouldn't that be closer to the accurate description than micro?

Mr. **Banks**. I think there are a lot of well-meaning people in the program. I am not sure that I would call them incompetent.

Senator **Nunn**. Well, I am not saying the people are, but the overall management scheme seems to be. You might have a few good people and just not have nearly enough of them. But if you were running the Department of Education, you would be very chagrined at all the things that are happening in this program, wouldn't you?

Mr. **Banks**. I believe that the Congress and the Department of Education should put the social goals together and let three data processing managers work the details out.

Senator **Nunn**. Let——

Mr. **Banks**. Three data processing managers that can systematize it, work the details out.

Senator **Nunn**. Did you say let three?

Mr. **Banks**. Three or four. Just some experts in computers and data processing. The problem with the program, we are sort of in 1970s computer technology right now.

Senator **Nunn**. Come in and just redo the whole program management system?

Mr. **Banks**. On the administrative part.

Senator **Nunn**. So you are saying you need a complete revamp of the data, the programming, the whole management scheme?

Mr. **Banks**. Correct.

Senator **Nunn**. Do you have an opinion or does your association have an opinion as to whether proprietary schools in general should continue participation in this program, or whether there should be a separate program set up for proprietary schools?

Mr. **Banks**. I guess with all the pressures in the budget, it is very expensive sector to serve and it sort of becomes a social trade-off, do we do it in job training, do we do it in post-secondary education. And again, I am not really not that expert in that social trade-off.

Senator **Nunn**. In other words, Congress and the Administration have to make up their mind how much money they are willing to lose to keep proprietary schools involved in it?

Mr. **Banks**. Correct.

Senator **Nunn**. On the data question, would you describe it a little bit more in terms of what is wrong with the program now? You are saying that they are basically trying to run this program in 1990 with 1970s technology?

Mr. **Banks**. Correct. For instance, a guarantee agency may have a PC-based origination system. The way the legislation in the program is, a school in Georgia is required to accept guarantor applications from all 48 States, whether the forms are 2 feet long or 12 inches long, and there is no standardized data format for receiving that information. So the forms are different, the data formats are different, and what that creates for a lender, the information on an application is the beginning step in due diligence. You can't tell upfront which borrowers are going to default, and when you are receiving information, that causes you basically to have to automate each separate guarantor, which is significant in computer programming time.

Senator **Nunn**. How many guarantee agencies would you say your bank works with?

Mr. **Banks**. We are dealing with seven.

Senator **Nunn**. Seven different ones. And so you have to have a different system internally to deal with each one of those?

Mr. **Banks**. Each one is a little bit different, and sometimes I wonder why the difference exists, but there are differences.

Senator **Nunn**. Do you have any comments to make about the cohort default list published by the Department of Education? Are you familiar with that?

Mr. **Banks**. On school default rates?

Senator **Nunn**. Right.

Mr. **Banks**. Yes. I think that most lenders have gotten attuned to looking at that since it came out. They started publishing it publicly I believe in the last 2 or 3 years, and it has sort of in some ways been the lender's self-defense to protect our own programs.

Senator **Nunn**. Should that list also set forth the cancellation rate, the annual and cumulative default rates at these schools?

Mr. **Banks**. I think the correlation between default and the default rate of the school is that significant an item. The return check rate or cancellation rate is really an expense item. It cost the bank X amount to do it, and if 20 percent of the loans are canceled, that cost us X dollars, but the real dollars come in in the actual collection and the loan that is disbursed. So I think default rate is a significant correlation.

Senator NUNN. Should the Department publish a list of default rates for lenders?

Mr. BANKS. I wouldn't have a problem with it. I think that lenders over the last 2 or 3 years are in general trying to manage their problem, they are providing opportunity for their inner city kids as well as their suburban kids. I really don't see a problem.

Senator NUNN. Regarding cancellation rates, default rates, refunds and all of that, do you have any rule of thumb about what the schools ought to be doing before you as a lender would continue to do business with them? Do you reach a threshold at which you say we just shouldn't be doing business with this school, it is too bad? Or since you have a full guarantee, does that just never enter into it at all?

Mr. BANKS. Well, clearly, a lot of schools would create more administrative burden when you have to keep rejecting the applications as incomplete, and that costs us time and money. I personally think the State licensing agency should be controlling the schools.

Senator NUNN. Not you. Do your lender members experience wide variations by the Department and guarantee agencies within the scope of program reviews or subsequent enforcement regulation? Is there a lot of variation?

Mr. BANKS. In general, the guarantors have to audit, I believe, their top 10 lenders bi-annually, and the Department of Ed comes in and audits our Fed biller every other year. The IG just sent in Price Waterhouse last January I believe and audited our Fed biller filings. So recent legislation I believe in the last 2 years really stepped up the required audit by the guarantors, and the Department I believe is funding this more than they did in the early 1980s.

Senator NUNN. Tell us a little bit about what is going to happen and how it affects lenders when one of these guarantee agencies has extreme difficulties or goes under. Walk us through an example. Your bank makes let's say 10 loans with a certain guarantee agency, that guarantee agency has extreme difficulties. What happens and where are you at risk? Where are your lenders at risk?

Mr. BANKS. Well, I believe the way the law is drafted, I believe we have a technical risk of the Department not honoring essentially the guarantee of a guarantee agency.

Senator NUNN. In other words, the full faith and credit of the Government is not behind that?

Mr. BANKS. I believe it is, and I believe the Secretary said it is, but I am not sure if the law is complete. One of our 7 points of reauthorization is to firm up that language.

Senator NUNN. Has it had an effect so far? Have you got lenders who are worrying about that?

Mr. BANKS. I believe so.

Senator NUNN. And what is the effect? Are they more reluctant to make student loans now?

Mr. Banks. Clearly, I think some of the publicity on the HEAF situation—the credit committees of the bank are handling hundreds of products, and bad publicity immediately raises flags.

Senator Nunn. Can you tell the affect on the lenders? Are there less loans now being made because of this? Are they shifting guarantee agencies, looking closely at them? What are they doing?

Mr. Banks. I believe lenders are looking at total loans outstanding with the guarantee agency. Based on the reserves of the guarantee agency, you should only have a certain dollar in outstandings, and reserves—basically, it is an insurance policy you have, and depending on whether the Feds are there or not there would depend on how big a reserve is necessary.

Senator Nunn. You are saying lenders are being more cautious now than they were?

Mr. Banks. Correct.

Senator Nunn. Has that affected students yet?

Mr. Banks. To my knowledge, I don't believe so, because I think in the HEAF situation the fact that $200 million went in from Sallie Mae, that the lenders with HEAF I believe continued to fund, but I am not real familiar with the situation in the Midwest.

Senator Nunn. Should lenders be required to disburse the entire loan amount and wait for the student's check to clear before the lender sells the loan on the secondary market or to another lender?

Mr. Banks. Operationally, this program has a lot of different variations, and in our chart I was reflecting a lender that originates and holds for the life of the loan, which my bank does. The variations, and because it is not a one-size-fits-all hat here that we are dealing with, some smaller banks have significant problems in trying to maintain any length or period of length of holding a loan, because you hold it for a week or 2 weeks, then they are required to have some collection expertise, which a lot of them don't have. So from a lender's point of view we would suggest we would probably want to—we would want to sell as quick as possible if I was a tiny lender. From the Government's point of view it can create confusion and possible default if it is sold before the check is negotiated.

Senator Nunn. So where do you come down on it? From a Government point of view, if you were in our situation would you be thinking about some requirement like that?

Mr. Banks. I have never thought of it, but it may be workable. I would like to see the data on it to see how big a problem it is.

Senator Nunn. In your statement you use the term "major banks," and yet we see that a couple of the biggest originating lenders are just major lenders, they are not major banks. Are you making a distinction between the two? We have got major lenders in this program—one of those has gone under now—that are not anywhere near major banks, they have just become huge lenders. Do you see a danger there?

Mr. Banks. I think the Congress did in putting a 50 percent rule in place, banks shouldn't have more than half their loans, 50 percent of their loans, from just good credit management.

Senator Nunn. Hadn't there always been a limitation on how much they were supposed to do, and hadn't that been ignored?

Mr. **Banks**. I am not familiar with the situation, so I don't know if it has been ignored or not.

Senator **Nunn**. Did any of your members or did your association foresee the problems with HEAF or the guarantee agencies? Did you know that there was this kind of problem brewing, or did you suspect there was?

Mr. **Banks**. From a credit analysis point of view, on a spreadsheet I think you can project if you have certain information. A lot of information a bank would have to guesstimate. It is normally not part of a Price Waterhouse statement what the school mix is, for instance. But it is predictable had you had enough data.

Senator **Nunn**. Did you?

Mr. **Banks**. We regularly police credits to guarantors, and our credit committee has to approve them.

Senator **Nunn**. In your bank you mean, or the association?

Mr. **Banks**. In our bank.

Senator **Nunn**. Does the association do any of that itself, or is this strictly bank by bank?

Mr. **Banks**. We had a survey of our lenders, and I believe only about 60 percent in the 1989 survey said they checked credit.

Senator **Nunn**. Sixty percent did and 40 percent didn't. But your association doesn't perform that service?

Mr. **Banks**. No.

Senator **Nunn**. What service does your association perform for your lender members in reference to student loans?

Mr. **Banks**. I think the main point is, based on this being a Washington contact, we have had the ability to on basically everybody sharing in the cost, have counsel interpret regulations for us, provide copies of regulations, and we as a group do meet from time to time with the Department of Education to discuss problems in the program administratively.

Senator **Nunn**. If you were running this program, if you were all of a sudden appointed to take over this program at the Department of Education and the Secretary said, "you recommend whatever you think needs to be done," based on your perspective now, what would you recommend?

Mr. **Banks**. I believe a whole lot——

Senator **Nunn**. And I am not talking about just laws, I'm including laws that need changing, but also rules, regulations, management. You mentioned a couple of them.

Mr. **Banks**. Right. Obviously, I went over the administrative data processing point. It does have to be reorganized.

Senator **Nunn**. A total revamp of data processing?

Mr. **Banks**. Meaning introduce computers, so that we share data records as if you were trading T-bills or T-bonds.

Senator **Nunn**. They are not using computers now?

Mr. **Banks**. Everybody is doing them differently, which causes problems.

Senator **Nunn**. So there is no system to it, is what you are saying?

Mr. **Banks**. Right.

Senator **Nunn**. And it is outdated technology?

Mr. **Banks**. Correct.

Senator **Nunn**. Any other suggestions?

Mr. Banks. I believe the biggest thing on the horizon is California last year—and a month ago New York—passed real tight licensing laws.

Senator Nunn. For the schools?

Mr. Banks. For the schools. I think the States really have to step up, and maybe Federal legislation could encourage the States in that direction.

Senator Nunn. So a much closer scrutiny of the schools themselves?

Mr. Banks. Right.

Senator Nunn. Particularly proprietary, I assume?

Mr. Banks. Proprietary, and again, a lot of community colleges serving inner cities have fairly high default rates.

Senator Nunn. Any other suggestions?

Mr. Banks. I believe I have covered the ones that I feel comfortable with.

Senator Nunn. Well, overall you believe that this is a sound program, it just needs better management?

Mr. Banks. It is a terrific leverage for the Government. We have $50, $60 billion out and we have put $115 billion out since 1965, and the fact is I believe the budget is $4 billion a year. So there is a terrific leverage effect in favor of the Government by keeping private industry in.

Senator Nunn. What does the $4 billion get you? What is the overall number?

Mr. Banks. Well, I'm just saying that each year I believe our budget, the post-secondary education budget, for our program is around $4 billion, of which we know $2.3 billion is defaults.

Senator Nunn. And how many loans on an annual basis, do you know?

Mr. Banks. About $13 billion in 1989, and I believe there has been 53 million borrowers in this program since 1965.

Senator Nunn. Okay. Could you furnish us a copy of your association's 1991 Student Loan Reauthorization Guide? I think you referred to that on page 20 of your testimony.

Mr. Banks. Sure.

Senator Nunn. Any other comments, Mr. Banks?

Mr. Banks. No.

Senator Nunn. Thank you very much. We appreciate you being here.

Our next witnesses are David Buckley, Chief Investigator of the Permanent Subcommittee on Investigations; Grace McPhearson, Staff Investigator, Permanent Subcommittee on Investigations; and Christopher Crissman, Senior Evaluator at the General Accounting Office. Both the Subcommittee and the GAO staff have been working on the case study for some months now, and Mr. Crissman brings 5 years of student loan program oversight experience with him.

I will ask all of you if you will take the oath. Do you swear that the testimony you give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. Buckley. I do.

Ms. McPhearson. I do.

Mr. Crissman. I do.

Senator Nunn. Who is going to lead off here this morning?

Mr. Buckley. I am, Mr. Chairman.

Senator Nunn. Okay, Mr. Buckley.

TESTIMONY OF DAVID BUCKLEY, CHIEF INVESTIGATOR, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Mr. Buckley. Mr. Chairman, the staff and the General Accounting Office have prepared a lengthy statement for the record which we will summarize this morning. I ask that the full statement,[1] the staff's exhibits, and GAO's report be accepted as part of the record.

Senator Nunn. Without objection.

Mr. Buckley. We believe that the case study will more than support the findings of the staff, so the majority of our verbal testimony this morning will be devoted to the incidents in California which have had a tremendous impact on the student loan program.

Today, we turn our focus to the financial players in the student loan industry: lenders, guarantee agencies, loan servicers, and the student loan secondary markets. Our investigation has confirmed that there are enough financial institution and servicer participants taking shortcuts, misrepresenting themselves, and engaging in fraud and abuse to cheat the taxpayer out of hundreds of millions of dollars and to seriously threaten the reputation and future stability of these programs. These abuses, combined with the legitimate and recognized payments involved in this program, have fueled a rise in costs far beyond any reasonable expectation.

Further, as with other parts of the program that we have examined, in this area we found that fraud and program abuse has historically not received the level of attention it should have received by the Department of Education. The Department of Education is, at best, a very poor enforcer of Federal law and regulation over program participants. Students continue to be at the mercy of a seemingly uncaring, and often unresponsive, massive bureaucracy of Federal program officer, huge banks, guarantee agencies, and their loan servicing center computers.

Briefly, our investigation found that skyrocketing loan volume and default rates, coupled with growing problems of waste, fraud, and abuse, have begun to adversely affect the continued financial stability of some guarantee agencies.

Our investigation found that many of the financial entities involved in the student loan program are far removed from any actual interface with the student borrower. As a result, they are often indifferent to the interests of the student, the policy objectives underlying the programs, and ultimately the interest of the taxpayers. In short, they are oftentimes part of the problem, not part of the solution. Student borrowers can become the unsuspecting fodder of lenders seeking quick profit.

Senator Nunn. Let me ask a question on the first point you made, guarantee agencies. How many guarantee agencies are there altogether?

Mr. Buckley. There are 56 the Department has identified.

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[1] See p. 165.

Senator Nunn. Do you have any idea how many of them are in trouble now?

Mr. Buckley. Aside from the Higher Education Assistance Foundation, the Department of Education is reviewing 16 guarantee agencies. They have advised that none of the 16 that they are reviewing right now have the potential losses that HEAF has experienced. But they do not have a firm number. They are still analyzing the situation.

Senator Nunn. Well, are those 16 being singled out because of certain signs that they may be in trouble, or is this just a random check of 16 out of 54?

Mr. Buckley. Well, the Department, in that list of 16, included the ones that were randomly selected and the ones that they think are in trouble, to mask the identities of the ones they think are in trouble.

Senator Nunn. There could be more or less that could be in trouble?

Mr. Buckley. Not all 16 are in trouble. Probably closer to five to eight.

Senator Nunn. How about those that aren't being checked? Are any of those in trouble? Or is the fact that they aren't being checked indicative of anything?

Mr. Buckley. I think——

Senator Nunn. Or do you know?

Mr. Buckley. Well, I don't know, but based on the rate that they are compensated for their reinsurance payments from the Department, the trigger, the 90 and 80 percent trigger, I think that is a key indicator. And none of the other guarantors are in the 80 percent mark that are being reviewed.

Senator Nunn. Your second point you make here about the fact that sometimes the financial entities involved in the program are far removed, are you talking about lenders here?

Mr. Buckley. Yes.

Senator Nunn. Or are you talking about the whole array of financial industries?

Mr. Buckley. I am talking about all of them: lenders, guarantee agencies, the loan servicing operations.

Senator Nunn. You heard the testimony of the previous witness about micromanagement and so forth. On this second point, do you have any observations on that?

Mr. Buckley. I think from what we have heard from the lenders and everyone else we have talked to, the guarantee agencies and the loan servicers are very upset with the required "due diligence buckets," as they call them—the sending of letters, the making of telephone calls at 30, 60, 90, 120 days—that are very firm in the regulation. If you miss one of those letters, that loan looses its guarantee of reinsurance unless it is cured by starting over again with due diligence collection efforts. I think that is what they call micromanagement.

But aside from those very specific collection requirements, we haven't seen anything that comes close to micromanagement.

Senator Nunn. Okay.

Mr. BUCKLEY. During our investigation, we found that the Department of Education simply does not regulate or oversee the guaranteed student loan secondary markets.

Our investigation found that as student loan volume has mushroomed, falsification of loan origination and collection information has occurred and has often gone undetected for long periods of time, at both loan servicing and lender operations. These problems can and do have a major impact on program costs and the collection of loans.

The financial players in the student financial aid program quickly discovered that loan volume drives profits—profits not available through the Pell Grant program. Our investigation confirmed that this realization, coupled with a growing pool of schools to create that desired volume, has driven the growth, and subsequent costs incurred, in this program. Contrary to what some have suggested, we do not believe that the program has expanded to the extent it has merely because the student grant program decreased and the student loans took its place.

As with other aspects of the program, our investigation found that the Department of Education's oversight of lenders, guarantee agencies, loan servicing operations, and secondary markets has proven poor. Poorer still is the Department's record of enforcement action once a violation has been discovered.

We found, during this phase of the investigation, that oversight of these program participants by the Department of Education has failed to adequately protect the student loan program from abuse. The system is late in arriving on the scene and slow to take adequate enforcement action against violators.

Mr. Chairman, the staff has selected for its case study an incident which occurred in California but has had major ramifications throughout the country's educational and financial arenas, and even in some foreign financial markets. Specifically, we examined the collapse of First Independent Trust Company of Sacramento, California, which had at one point become one of the Nation's largest lenders in the student loan program. This is a matter that remains unresolved and is being heavily litigated. It represents what can happen in Government-sponsored programs when there is little effective oversight combined with the readily available funds and delayed reaction by regulators.

Our findings include, among others, the following: Despite continuous adverse findings made by the California State Banking Department regarding the financial condition of FITCO, the Trust Company was allowed to continue to operate in the State's banking system and in Federal student loan programs, eventually becoming one of the Nation's largest lenders of student loans. We found that FITCO's collapse was precipitated by abuse, mismanagement, and possible fraud, including the failure to pay origination fees to the Department of Education, the failure to file timely reports to the Department of Education, the failure to make refunds or process loan cancellations, and serious shortcomings in the servicing of loans FITCO had originated by United Education and Software.

A profit motive drove the huge volume of loans at FITCO and UES. Both companies were incapable of handling the volume of the loans generated. UES employees, realizing the dilemma, falsified student borrower and collection files. There was no Federal oversight or regulation of the secondary market involved in the FITCO incident.

Communications among regulators, both Federal and State, and others with oversight responsibility in the FITCO scenario was slim to non-existent. Oversight and enforcement efforts by the Department of Education in this instance, as with others, fell far short of that which is needed to ensure program integrity and to protect taxpayers.

Mr. Chairman, I am going to ask that Mr. Crissman from GAO summarize the report that they are submitting this morning, and then Ms. McPhearson will continue with our summary.

Senator Nunn. Mr. Crissman?

TESTIMONY OF CHRISTOPHER C. CRISSMAN, SENIOR EVALUATOR, GENERAL ACCOUNTING OFFICE

Mr. Crissman. Thank you, Mr. Chairman.

I do not have a prepared statement, but I will summarize our report done at your request concerning the activities of the First Independent Trust Company, otherwise known as FITCO. I would first like to acknowledge the staff from our Los Angeles office that assisted me on this assignment who are in attendance today. These individuals are Revae Steinman, Cheryl Gordon, and Carla Brown.

Senator Nunn. We appreciate all of your assistance. Thank you for your help and thank you for being here.

Mr. Crissman. Mr. Chairman, you specifically requested information addressing four objectives. You asked that we, one, describe the chronology of events concerning FITCO, including when it began and ceased operations; two, analyze FITCO's loan portfolio; three, determine whether it owed moneys to the Department of Education; and, four, summarize the audits and reviews of FITCO conducted by various organizations.

Before I start summarizing our results, I would like to briefly discuss some background information concerning the Stafford Student Loan Program and its relationship to FITCO. The program consists of three types of loans: Stafford loans; Parent Loans for Undergraduate Students, also known as PLUS; and Supplemental Loans for Students, also known as SLS. These loans are guaranteed by State or private non-profit guarantee agencies and are reinsured by the Federal Government against borrower's death, disability, bankruptcy, and default. Students receiving Stafford loans pay a 5 percent origination fee and up to a 3 percent insurance premium. PLUS and SLS borrowers pay no origination fee but may pay up to a 3 percent insurance premium. The origination fee helps offset the Government's cost of subsidizing the program, while the insurance premium is used by the guaranty agencies to help offset their administrative costs.

FITCO made all three types of loans. Its primary practice was to sell the loans it originated to a secondary market quickly, often within a few days of their origination. FITCO could then use these loan proceeds to make new loans.

Now I would like to discuss the results concerning the first objective: a chronology of events concerning FITCO. Our report includes an appendix analyzing 31 selected milestones involving FITCO which cites the beginning of its initial operations in September 1975, includes the date when it was closed by the California State Banking Department in May 1989, and ends with the suit filed by State Banking against FITCO in June 1990.

This appendix also includes other dates, such as when the California Student Aid Commission, also known as CSAC, and the Higher Education Assistance Foundation, also known as HEAF, began guaranteeing loans for FITCO in 1979 and 1986 respectively. These 2 agencies guaranteed almost all of FITCO's loans.

To answer your second area of interest, FITCO's portfolio, we used data provided by CSAC and HEAF to review the loans these agencies guaranteed. We found that FITCO had net disbursements of over $1 billion that were guaranteed by CSAC and HEAF. This information has been provided in a handout for the Subcommittee. It shows that for this amount, $519 million was guaranteed by CSAC and $569 million was guaranteed by HEAF.

One fact which we were still analyzing but didn't have time to include in the report was that both agencies had guaranteed much more in loans for FITCO than what was net disbursed. In fact, the preliminary results show that almost 28 percent of CSAC's and 37 percent of HEAF's loans were later canceled by these guarantors. Department officials told us that the national average for cancellations is about 13 percent.

Senator NUNN. What does that indicate to you? What does that mean?

Mr. CRISSMAN. I don't know all the reasons, but I can make a guess as to that. It means that a lot of loans were made quickly. Maybe the students reconsidered and changed their minds, and when the checks got there, the students didn't show up at the school, and the checks were subsequently returned to FITCO.

Senator NUNN. And then what happened?

Mr. CRISSMAN. If FITCO had sold those loans, then it was up to FITCO to notify the purchaser of the loans that the loans were canceled.

Senator NUNN. Did they do that?

Mr. CRISSMAN. I think in some of the reviews that were done later by other organizations, there was some concern about whether the secondary markets were quickly notified.

Senator NUNN. Okay. In the meantime, what happens to the money? FITCO has gotten reimbursed for something that it has never really paid out. They really have been double paid for a period of time. What happens to the money?

Mr. CRISSMAN. That money, I would imagine, would still end up in FITCO's bank accounts for their subsequent payment to the secondary market. But I don't know exactly what kind of time frames it took them to send that money forward.

In addition, we found that most of FITCO's loans went to students attending proprietary schools. At least 68 percent of CSAC's loans, $355 million, and 96 percent of HEAF's loans, $547 million, were eventually disbursed to students attending these types of institutions. That has also been provided in the handout.

When the lender files his quarterly bill with the Department for interest and special allowance subsidy payments, the Department offsets any origination fees it is due. For example, if a lender is due $1 million in interest and special allowance and owes the Department $400,000 in origination fees, the Department would pay the lender $600,000. Conversely, if a lender owes more origination fees than interest and special allowance, it should send the Department a check for the difference.

Our third objective was to examine the potential moneys that FITCO may have owed the Department when it was closed by State Banking. Much of the activity concerning FITCO centered on the late payment of origination fees. At one point, FITCO owed the Department over $13 million in origination fees from loans originated in 1987. These fees were not paid until April 1988.

FITCO also owed the Department another $5.5 million in fees after it ceased operations. However, the Department later agreed to settle this outstanding amount for $4.4 million. The Department told us that it agreed to the lesser amount with State Banking, as the liquidator of FITCO, after considering such factors as the litigation risk of pursuing the $5.5 million. In addition, the Department indicated that the deadline for amending its proof of claim filed with State Banking for the $5.5 million had already expired. So it was too late to amend their claim.

The last area you asked us to address was to summarize the results of audits or reviews of FITCO's operations. We could identify 21 audits or reviews during FITCO's 14-year period. These examinations were conducted by the State Banking Department, the Department of Education, CSAC, and HEAF. The audits or reviews found minor and major deficiencies. An example of a minor deficiency was that FITCO failed to use new student addresses, which it knew, to mail delinquency letters. A major deficiency was that FITCO did not file its interest billings on time and owed the Department origination fees, such as the $13.3 million I mentioned previously.

The State Banking Department examination reports cited problems in FITCO's financial operations as early as December 1975 and found generally unsatisfactory conditions as early as November 1976.

Mr. Chairman, that completes my summary of our report. I will be happy to answer any questions you may have.

Senator NUNN. In your own words, based on your investigation and so forth, what do you believe primarily went wrong at FITCO? And who, not necessarily by name of the individual, but by institution, who is at fault? What went wrong here?

Mr. CRISSMAN. I think you had a case where there was a large volume of loans that FITCO originated that kept getting bigger and got larger very quickly. As a result, there was a lot of activity going on.

In looking at the reviews that were done of FITCO by these different organizations, I think it kind of highlights some things you mentioned earlier in your other hearings, in that a lot of these reviews found that there were some problems at FITCO. However, there really wasn't a communication network set up between the different groups to share this type of information.

I think there were a lot of problems that some people knew about, but it was kind of too late.

Senator **NUNN**. What alarm bells should have gone off here to prevent this from happening?

Mr. **CRISSMAN**. I think Mr. Banks mentioned some of the things earlier. One of the things that the Department is starting to get a better handle on is information systems. I think what it needs is the type of indicators that monitor the lenders, schools, and guarantors a little quicker. Now it is starting to get that capability. But the alarms that went off earlier mainly came from the State Banking examinations, California's program reviews, and HEAF's program reviews. But, again, it was kind of late in 1987, 1988 when many of these things were discovered.

Senator **NUNN**. Ms. McPhearson, I think you are going to give us a summary of the case study.

TESTIMONY OF GRACE McPHEARSON, STAFF INVESTIGATOR, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Ms. **McPHEARSON**. Yes, sir. Mr. Chairman, in examining our case study of FITCO, I will begin with a brief history of the Trust Company.

An historical picture of California's first directed trust company reveals poor marks from the beginning.

In 1975, First Independent Trust Company opened in Carmichael, California, under a charter from the California State Banking Department, who at one time attempted to deny the charter. FITCO was developed under the direction of its first and only president, Deno Evangelista.

According to California State Banking Department reviews, FITCO from its inception received poor marks for its business operations and was consistently short on operating capital. Despite these facts, in 1980 FITCO was given a lender identification number by the California Student Aid Commission and allowed to participate as a lender in the federally guaranteed student loan programs. FITCO's loan volume grew to the extent that it became the largest lender of guaranteed student loans in California, as well as for a time in 1987 and 1988, the second largest lender of student loans in the United States. FITCO is estimated to have originated approximately $1.5 billion in student loans in its 9 years in the program.

FITCO, a trust company that was not insured for State banking purposes but operated under the guidelines of a State-chartered bank, had no backing by the Federal Deposit Insurance Corporation, Federal Savings and Loan Insurance Corporation, nor was it a member of the Federal Reserve System. Therefore, FITCO was not subject to review by any Federal bank examiners.

Senator **NUNN**. Were they subject to any rule anywhere that limited a percent of their overall loans that could be in student loans?

Ms. **McPHEARSON**. I believe in the beginning of its participation they were not. In reauthorization in 1981, the 50-percent rule was installed, and that limited the amount of volume.

Senator **NUNN**. That is by Federal law.

Ms. **McPHEARSON**. Yes, sir.

Senator **NUNN**. But they weren't subject to banking laws on that. That was basically a student loan law; is that right?

Mr. **Buckley**. That is correct. The Higher Education Act prohibits lenders from doing a majority of their consumer credit business in the student loan program.

Senator **Nunn**. Did they violate that act?

Mr. **Buckley**. Yes, they did, up until 1986 when the Congress changed the Higher Education Act in the 1986 reauthorization.

Senator **Nunn**. To do what?

Mr. **Buckley**. We have a chart that depicts that specific language in the bill, Senator. In 1986——

Senator **Nunn**. In other words, from 1981 to 1986, FITCO was making more than 50 percent of their loans in student loans?

Mr. **Buckley**. Well, specifically 1984, 1985, 1986.

Senator **Nunn**. And they were in violation of the Federal law then?

Mr. **Buckley**. That is correct.

Senator **Nunn**. And nobody did anything?

Mr. **Buckley**. No one did anything. The State Banking Department raised the issue for the first time in the fall of 1985 and carried that issue over until the early winter of 1986.

Senator **Nunn**. Did the Department of Education know what was happening?

Mr. **Buckley**. We don't know.

Senator **Nunn**. You don't know whether the State Banking complaints got to the attention of people in Washington; is that right?

Mr. **Buckley**. That is correct. We were not able to determine that.

Senator **Nunn**. Okay. What happened in 1986?

Mr. **Buckley**. In 1986, the phrase "a trust company" in the eligible lender definition was inserted in the act, making trust companies eligible to originate and hold or sell student loans.

Senator **Nunn**. What does that mean? Does that mean they don't have to meet the 50-percent rule?

Mr. **Buckley**. No, Senator. In the first part of the legislation, it says—and this is the definition of "an eligible lender": A national or State-chartered bank, a mutual savings bank, a savings and loan association, a stock savings bank, a trust company or credit union. In 1986, both "a stock savings bank" and "a trust company" were inserted into the definition.

Later on in the language, it has the general prohibition there, (ii), "These lenders must be subject to examination and supervision by an agency of the United States or of the State in which its principal place of operation is established", and the prohibition: "does not have as its primary consumer credit function the making or holding of loans made to students under this part, unless"—and then the exemption for FITCO specifically—"it is a trust company which makes student loans as a trustee pursuant to an expressed trust and which operated as a lender under this part prior to January 1, 1981."

Our investigation showed that that language, that second provision, was FITCO-specific.

Senator **Nunn**. That was the only organization involved?

Mr. **Buckley**. They are the only trust company which was making student loans prior to January 1, 1981.

Senator Nunn. So that language in the law in 1986 basically exempted them from the 50-percent limitation.

Mr. Buckley. That is correct.

Senator Nunn. And they were already violating that, right?

Mr. Buckley. They were violating it when that law was amended.

Senator Nunn. Why did the law need changing if they were violating it with no consequence?

Mr. Buckley. Well, the Federal Government or the guarantee agencies weren't bringing the matter to light. It was the State Banking Department.

Senator Nunn. So this was something passed in the Congress that basically got the State banking authorities off their back; is that right?

Mr. Buckley. Yes. And we were told that this change in law had a very chilling effect for some of the examiners at the State Banking Department. Mr. Evangelista had boasted that, "Yes, in litigation I can get this changed if we have to take it to court, but it is going to be easier for me to get the Federal law changed." And they laughed, privately. Then when the law was changed, it was like throwing ice water in their face.

Senator Nunn. Easier to get Federal law changed than to deal with the State regulators?

Mr. Buckley. Or to litigate the question of whether or not they could originate these loans.

Senator Nunn. Okay.

Ms. McPhearson. In May 1989, FITCO was declared insolvent and closed by the State banking officials after suffering crippling financial losses during 1988 and the first quarter of 1989. The acting superintendent of banks was quoted saying, "It was necessary to close the trust company as a protection to customers, creditors, and the public." At the time FITCO was declared insolvent, it had in the first 5 months of the year already originated nearly $49 million in student loans, making it the 48th largest lender of student loans for all of 1989.

FITCO's unsound business practices, including those related to the student loan program, have had a domino effect throughout the student loan community, resulting in losses for thousands of investors, skepticism about the viability of the student loan program as it exists today, and certainly a black eye for the Department of Education.

Senator Nunn. How much loss did the taxpayers take on FITCO? Does anybody know?

Mr. Buckley. I don't think we know specifically. The Higher Education Assistance Foundation——

Senator Nunn. There was no loss to the FDIC or the FSLIC because there was no guarantee there for depositors, right?

Mr. Buckley. Personal investors, the trust investors at FITCO, are being held accountable for some of the losses in this program.

Senator Nunn. By?

Mr. Buckley. By the State Banking Department and the U.S. Department of Education.

Senator Nunn. So the losses aren't sure yet. Do you have any range of losses?

Mr. BUCKLEY. Well, Senator, if you are going to include the whole bucket, including FITCO defaults, and additional costs because they failed to cancel loans and forward that money on to the secondary market, we have no idea. Once you start tallying up the additional costs that this fiasco created—I don't think anybody has done that.

Senator NUNN. Have those costs been paid yet, or are those bills that are coming due later?

Mr. BUCKLEY. I think they are coming due now, and they will be coming due in the future. And I think that some of the subsequent witnesses will testify about some of the losses that they are personally experiencing because of this.

Senator NUNN. How about the people who had put the money in FITCO, depositors?

Mr. BUCKLEY. Tomorrow morning, Greg Voelm, who represents thousands of individual investors, will testify about the losses that they have so far experienced, and also the ones that the Department is trying to hold them accountable because of the actions of FITCO.

Senator NUNN. Okay.

Ms. MCPHEARSON. Participation in State banking program and Federal student loan programs allowed despite unsound business practices.

As mentioned earlier, in 1980, FITCO was given a lender identification number by CSAC and, as a State-chartered trust company, became eligible to buy, sell, originate, and hold student loans. As CSAC provided schools with the names of lenders participating in the student loan program, FITCO was able to increase its loan volume, soon making loans to students throughout California.

Beginning in 1983, FITCO trust investors were encouraged, through somewhat misleading advertising, to invest in its trust rate accounts for the purpose of providing student loans. Such advertising, examples of which are attached independent to this statement and one of which is displayed, was criticized by the California State Banking Department in its 1985 and 1986 reviews. This advertisement reads, "First Independent Trust, The Intrust Bank," and there at the bottom, "The guarantee on Trust Rate is the full faith and credit of the U.S. Government, which is exactly the guarantee given if you were to purchase T-bills. Also, the full faith and credit of the U.S. Government is the highest priority guarantee for a financial instrument; safer than the FDIC or FSLIC which are secondary to the full faith and credit of the U.S. Government."

Senator NUNN. Where were they getting that claim? You said "somewhat misleading." Where was that claim coming from? What were they basing that on?

Mr. BUCKLEY. It has no basis in fact. They invested the trust rate accounts in the guaranteed student loans. They made student loans with the investors' money.

Senator NUNN. So they were saying that the Government was backing up the student loans? Is that what they were saying was the full faith and credit?

Mr. BUCKLEY. That is correct.

Senator Nunn. Well, what is accurate? How would you describe it? Because the Government——

Mr. Buckley. Well, what they are not telling the investor here, Senator, is that if the originator, FITCO, messes up in the origination of that loan, or if the servicer later messes up in the servicing of that loan, that loan may lose its guarantee. And that is what happened here. FITCO failed miserably in the forwarding and the processing of origination fees, making refunds, and then UES servicing of those loans later. There is a substantial portion—I think 33,000 loans—that have lost their guarantee.

Senator Nunn. Okay.

Ms. McPhearson. These trust rate investments were not always used for the purpose that was intended. According to State banking records and interviews the Subcommittee has conducted, we have learned that numerous unsecured loans were allegedly made to Evangelista's influential friends and associates from these trust rate accounts. These sources have also revealed that money from the corporate account was often comingled with that of trust rate accounts.

Senator Nunn. So what you are saying is that they not only were greatly exaggerating this down here and leaving out some key elements in that advertisement, but they also were making loans outside the student loan program?

Ms. McPhearson. Yes, sir.

Senator Nunn. And what type loans were those?

Ms. McPhearson. Loans were made to some of Mr. Evangelista's friends that the State Banking Department has described as unsecure. There were no credit histories. There was no collateral on these loans.

Senator Nunn. You don't have any idea what the volume was on those?

Ms. McPhearson. No, sir, I don't.

Senator Nunn. So, in effect, they had no guarantee at all by the Federal Government?

Ms. McPhearson. Correct.

Senator Nunn. So this is not just somewhat misleading as to those investments. That is false, completely false, right?

Ms. McPhearson. Yes, sir.

When the secondary market in California did develop, FITCO's loan volume grew tremendously. In April of 1986, FITCO entered into an agreement with the California Student Loan Finance Corporation to sell CSLFC student loans originated by the trust company.

As the demand for student loans from FITCO increased, its ability to initially fund the loans from its trust resources was exhausted. It became a necessity for FITCO to immediately sell its student loans to the secondary market in order to generate capital to originate additional loans. In the beginning, FITCO sold its loans within a week, but as its volume grew, the loans were sometimes sold the same day or even within hours.

This led to the further problem of loan cancellations not being forwarded in a timely manner to the institution owning the paper.

To increase the speed with which it could make loans, FITCO provided schools with free computers to use in-house to process loans made from FITCO to their own students. Six hundred schools in 43 States were provided PC's and FITCO software to process the students' loan applications.

In 1987, the Department of Education cited FITCO for this practice as an inducement, a violation of the law.

United Education and Software was a corporation that in addition to servicing student loans produced education-related computer software and operated a chain of proprietary schools based in Los Angeles. In 1984, UES signed a contract with FITCO. Under the contract, UES would actually make loans for FITCO using the trust company's money. The Subcommittee staff has found that origination of loans by UES to students of its own correspondence courses appears to be a violation of Federal regulation.

Senator **NUNN**. Are those criminal violations, or just civil?

Mr. **BUCKLEY**. I think they are civil/administrative, unless you have criminal intent. The Department can just take administrative action.

Senator **NUNN**. Are there criminal investigations going on in this case?

Mr. **BUCKLEY**. In the entire matter? Yes, Senator, do you want a run-down of them? The Department of Education Inspector General and the FBI are investigating fraud at United Education and Software regarding the loan servicing of the $1.4 billion portfolio. The California Attorney General's Office is investigating United Education and Software proprietary schools. They have filed for bankruptcy and I think they are in reorganization or being sold. The Sacramento District Attorney has initiated a criminal investigation of First Independent Trust Company. The California Auditor General is now investigating not only FITCO, but also the State Banking Department's handling of First Independent Trust in liquidation.

Aside from that, I don't think there are any others. There are no Inspector General or FBI Federal investigations of First Independent Trust Company at all.

Ms. **McPHEARSON**. UES serviced the loans that it originated through FITCO for CSLFC, which had directly purchased the loans for FITCO. In addition to CSAC guaranteeing a significant amount of FITCO loans, the Higher Education Assistance Foundation, HEAF, a national guarantor, also did a great deal of business with FITCO. In 1985, the two entered into an agreement in which HEAF guaranteed loans valued at nearly $900 million to students attending 898 different eligible institutions. In 1989 HEAF, as a result of its program review, decided to suspend and finally terminate it agreements with FITCO regarding participation in the student loan program. HEAF cited six ongoing violations that were of such seriousness and magnitude that substantial losses to the borrowers, HEAF, and the Department of Education were likely. These violations included, among other things, numerous refund problems, failure to pay outstanding guarantee fees, and failure to file quarterly interest and special allowance reports, or pay origination fees.

According to FITCO employees, FITCO filed its quarterly forms 799 in a timely manner from 1981 to 1986. Reviews and audits indicate that the trust did not regularly submit these forms. No penalties were levied by any agency for FITCO's failure to file. To further this problem, it appears FITCO did not timely file 799s for a good portion of its loans originated by UES. The dollar amounts owed between the Department of Education and the lender is determined from the 799 forms. Because FITCO was quickly selling the large volume it originated, very little interest and special allowance was allowed to accrue. As loan volume grew, the origination fees owed to the Department continued to mount and were great enough to never be offset by the interest and special allowance. This occurred in 1984 and continued throughout most of FITCO's existence.

According to Evangelista, when it was first discovered by FITCO that FITCO owed the Department origination fees over and above the special interest and allowance it was due, FITCO mailed to the Department a check for $16,000. Again, the Department was used to the offset method of payment in accounting for these funds. It was not accustomed to receiving actual money and thus could not process the incoming funds. The check was returned to the trust company and FITCO was told to hold on to the payment with the hope that eventually the amounts would offset. Department officials have admitted to staff that this could very well have occurred but they have no official record which would confirm it.

Senator NUNN. So the Department of Education doesn't have any way of receiving money?

Mr. BUCKLEY. It does today. It didn't then.

Senator NUNN. What year was that?

Mr. BUCKLEY. We have one witness that told us it was as early as 1983, but it is impossible to tell from the records that we have.

Senator NUNN. How do they handle it now?

Mr. BUCKLEY. They bill the lender. They analyze the quarterly report from the lender. If there is an offset, the Department is due money, then the lender is sent a bill. Now, FITCO was billed. This allegedly occurred the first time very early in the program. After that, FITCO did receive bills and was being billed for that $13.3 million that it had failed to pay. But no one bothered to pick up the phone and say, "hey, aren't you getting the bill, send the $13 million."

Ms. MCPHEARSON. According to records in the staff's possession, the Department knew as early as 1984 that FITCO needed to pay origination fees. Yet, it did not aggressively attempt to collect this money until the late 1980s when a guarantee agency cited the alarming problems. Origination fees were taken from the students' loans and deposited in the G.O.F. account, which stood for "Government Origination Fees."

We were also told that Evangelista had moved this account to the Bank of America where it was deposited in an interest bearing account, allowing FITCO to collect interest on money that in fact belonged to the Department. Today the actual dollars that were withdrawn from the students' loans for these fees cannot be accounted for dollar for dollar. One former FITCO employee told us that when capital at the trust company was scarce, FITCO officials withdrew funds from the G.O.F. account and used the money for interest payments to its trust rate clients and for other corporate liabilities.

There remain other outstanding concerns as a result of FITCO's failure to pay the Department for missing origination fees. What is the actual amount of dollars due the Department for the missing origination fees? Who will be held accountable for payment of these fees? What is the status of the student loans as far as Federal reinsurance if the origination fees were not paid? And why did it take so long for oversight personnel to discover and act on what has become a very significant aspect of the FITCO story?

FITCO was cited on numerous occasions by the Department of Education, the Higher Education Assistance Foundation, CSAC and California State Banking for problems associated with refunds and cancellations, and I believe this is something you had asked about earlier. A loan is normally canceled if the borrower decides not to accept the loan or not to enroll in school. Schools are supposed to send unclaimed loan checks back to lenders so that the loans can be canceled. As long as the loan remains in the lender's inventory of loans or investment portfolio, the Department pays interest and special allowance on it each quarter. In the FITCO case, delays associated with removing loans from the investment portfolio resulted in excessive interest and special allowance being paid to FITCO on the canceled loans.

Refunds were also due student who left school before the term was complete. A former FITCO employee we interviewed discovered $1.8 million in refunds and cancellations that needed to be forwarded to the appropriate holders of the loans. When this request for $1.8 million was made to the accounting department, the request was denied because the money was not accessible. The employee was told by the accounting department that the funds were tied up in corporate certificates of deposit that had not yet matured.

Staff also learned that FITCO was originating new student loans from the refund money that it had not yet forwarded to the secondary market. We have also learned that the trust company used this refund money to pay some of its corporate expenses.

Given these internal problems, FITCO's overall performance in the GSL program is not surprising. HEAF has reported that its FITCO paper has defaulted at a rate of approximately 80 percent.

Legislative changes confirmed FITCO's eligibility to participate in Federal student loan programs.

Senator NUNN. What was the default percentage that HEAF reported?

Ms. MCPHEARSON. HEAF paper was defaulting at a rate of 80 percent.

Senator NUNN. Eighty percent from FITCO?

Ms. MCPHEARSON. Yes, sir.

Mr. BUCKLEY. FITCO originated paper.

Senator NUNN. Do you know any other guarantee agencies' experience, or just HEAF?

Mr. BUCKLEY. We have California's.

Mr. CRISSMAN. We had a figure of 68 percent of loans originated to proprietary schools, Mr. Chairman. Maybe Mr. Kipp when he testifies subsequent to this would have that figure.

Ms. MCPHEARSON. Oversight by State regulators as a precondition for participation, is it adequate or is it misplaced?

According to records reviewed by the staff from 1975 to 1988, the California State Banking Department conducted nearly annual reviews of FITCO. None present a promising picture. In fact, several of these reviews were quite damning. Yet the trust company was allowed, even without being fined, to continue to operate under California banking laws, as well as in federally insured loan programs. While we are critical of the Banking Department for allowing FITCO to continue to operate, we are also critical of the Federal system for relying so heavily on State regulators as a precondition for participation in this Federal program.

The U.S. Department of Education, clearly having an oversight role related to the Federal student loan program, fell miserably short as a regulator of its own program.

Despite FITCO's reign as one of the top lenders of student loans in the country and the recognized problems it was having, the Department of Education conducted only four reviews from 1981 to 1989. These reviews combined total fewer than 16 pages, with only a relatively limited number of findings.

Our examination of reviews conducted by other bodies confirms that the problems previously mentioned continued to exist at FITCO during the time the Department did its reviews.

In the Department's first review of student loan activity, conducted in 1981, only two findings were made, as can be seen from this chart. Both of these findings continued to regularly occur in some fashion throughout the existence of the trust company. A close examination of all reviews of FITCO showed this pattern of recurring problems.

As problem after problem developed with FITCO's increased student loan volume, the Department's recognition of and action on the problems did not correspond. While some corrections were made in the company's advertising and certain inducements were eliminated, little forceful action of major issues was taken by the Department until 1988 when it aggressively sought payment of past origination fees and submission of delinquent 799 forms. Moreover, our examination found a lack of investigative incentive regarding the FITCO fiasco at the Department's Inspector General's Office. Neither that office nor the FBI is conducting any type of criminal investigation into the operations of the trust company or the officers.

FITCO's secondary market, the California Student Loan Finance Corporation. Mr. Chairman, the staff has found that FITCO's secondary market failed to adequately check the loans it purchased from FITCO and UES on behalf of FITCO, failed to safeguard the guarantee on those loans through proper servicing, failed to properly bill the Department of Education for interest and special allowance for the loans in its portfolio, and failed in its fiduciary responsibility to the student borrowers whose accounts it maintained.

The California Student Loan Finance Corporation is a nonprofit, public benefit corporation that operates exclusively to acquire student loan notes incurred under the Higher Education Act of 1965, as amended. Its initial financing and acquisition of student loans as what is commonly called a secondary market began in October 1981. The Bank of America became CSLFC's corporate indenture trustee.

In 1982, after CSLFC sent letters to lenders throughout California stating the non-discriminatory nature of its purchasing, its business began to grow. CSLFC purchased student loans from eligible lenders, generally arranged them into bond packages worth $75 million to $100 million, and set up an indenture for each bond offering. As depicted in the appendix, CSLFC as of September 1989 was the third ranking holder of guaranteed student loans in the country.

Letters of credit from various banks, primarily foreign, were obtained and proved critical in that they provided financial security for CSLFC to purchase additional student loans. According to Jay Olins, the founder and former president of CSLFC, CSLFC signed an agreement with FITCO to buy its loans in 1986. FITCO agreed to sell the loans at a face value plus 1 percent with the understanding that if the student's loan was canceled, FITCO would return the 1 percent fee to CSLFC. We were told that 22 to 25 percent of the CSLFC 1989 portfolio was made of canceled loans or loans due partial refunds. CSLFC contends that FITCO owes the corporation nearly $10 million in overall claims. CSLFC also contends that the trust company was paying its corporate expenses from this money that was due the corporation.

Trent Nebeker, formerly of the Bank of America, was the CSLFC officer who was the most knowledgeable of the operations at UES, the servicer handling FITCO originated loans. Problems quickly developed with the increased loan volume that FITCO originated, CSLFC bought, and UES serviced. In 1987, UES experienced computer conversion problems that prevented the servicer from adding incoming accounts to its system. Eventually this problem and others ballooned to such an intent that a great volume of UES-serviced loans lost their guarantee.

The Department of Education pulled its guarantee of the loans mishandled by UES in March 1989, an event that rippled throughout the student loan community and affected a great number of players, literally around the world. Nebeker said that he was never aware of a backlog of work at UES, and former UES workers confirmed that UES hid the obvious indicators from CSLFC.

At the point that UES servicing began to fall apart, CSLFC owned over a billion dollar student loan portfolio that was nearly equally guaranteed by CSAC and HEAF. The guarantors no longer honored the loans spoiled by UES' lack of due diligence. The letter of credit banks, many of which were foreign and backing student loans because of their Federal guarantee, now feared some of what was held out as Government guaranteed was worthless paper.

The Bank of America as trustee of CSLFC is also facing criticism for its role in the fiasco. Because CSLFC was not an eligible lender of student loans, the Bank of America agreed to allow it as its trustor to use its lender number in the buying, selling and holding of students loans. Loans contained in the CSLFC portfolio are held in title by the Bank of America on behalf of the corporation. The bank contends that as trustee it did have some administrative processing duties over the indentures, but no oversight responsibilities of a managerial type. Also, according to the Bank of America officials, the bank had no contract with UES for servicing. Rather, there was a trust department agreement with the servicer.

Bank of America officials told the Subcommittee staff that at one point the bank questioned whether UES could handle the increased loan servicing volume and the new due diligence requirements resulting from the 1986 amendments to the Higher Education Act. The bank was assured by UES that it could handle the changes in loan servicing requirements. The bank maintains it had no knowledge of the CSLFC and UES problems until 1988 when the Department of Education Inspector General's office and HEAF discovered them. The Bank of America attempted to determine the extent of the damage to the CSLFC portfolio, and by November 1988 UES was replaced as the servicer by Costa Mesa Servicer Center.

In determining the extent of damage done to the portfolio, Bank of America found and reported to the Department of Education two computer programs FIX and COMFIX, that were apparently created at UES to falsify due diligence activities on a number of student loans in 1987.

Bank of America's problematic trustee status related to servicing of CSLFC loans is not limited to UES alone. A relatively small portion of CSLFC's portfolio—$135 million in loans—was serviced by Mitchell Sweet and Associates, a privately owned student financial aid consultant and loan servicer. In 1988, a program review of Mitchell Sweet and Associates was conducted jointly by the Inspector General of the Department of Education and HEAF. It was concluded that the servicer had engaged in systematic falsification of loan collection activities from May through July 1988. Employees entered fictitious phone calls and back-dated missing letters and system records to conceal that required due diligence steps had not been performed. Mitchell Sweet and Associates continues to service loans for CSLFC and other markets today.

Portfolio problems. The CSLFC portfolio has four readily identifiable problems that should be mentioned. First, when CSLFC purchased the majority of its student loans from FITCO it inherited a default problem that has become almost synonymous with a portfolio made of a large amount of proprietary school paper. Secondly, FITCO's multiple disbursement practices also presented a problem for CSLFC. FITCO often disbursed its loans in installments and sold the installments to the secondary market. This procedure was agreed to by CSLFC and FITCO, yet CSLFC failed to maintain the separately disbursed loans as single loans. CSLFC placed the disbursements into separate bond offerings. This creates servicing problems down the road if the disbursements are not consolidated into the single loan they represent.

Thirdly, it was mentioned earlier that FITCO originated and sold its loans at a very rapid rate. This rate did not allow time for students to cancel their loans before the loans were sold to CSLFC.

Fourth, a great number of refunds that should have been forward to CSLFC or UES by FITCO were not. By not reaching the secondary market, these cancellations and refunds caused considerable confusion and undue expense. The Department of Education undoubtedly paid excessive interest and special allowance to CSLFC over the years.

United Education and Software. UES was started by Aaron Cohen around 1980 as a company which owned and operated a string of technical and proprietary schools. UES began servicing the loans sometimes in the late fall of 1982 and by 1987 was servicing a $1.2 billion portfolio of student loans. More significantly however, UES was also a company in which improper, if not illegal, steps were taken to cover up its problems. In fact, by the summer of 1988, UES' operation had deteriorated to such a point that a program review of UES jointly conducted by the Department of Education, CSAC, and HEAF concluded, "UES has demonstrated no ability whatsoever to service loans in accordance with Federal regulations. UES' performance has caused unmeasurable hardship to hundreds of thousands of borrowers and has cost guarantors, the United States Government, and taxpayers millions of dollars. Borrowers being serviced by UES deserve a first chance to repay their student loans. UES does not deserve a second chance to service these loans."

If a borrower fails to make payments, the servicing company is obligated to perform what is known as due diligence. UES performed, or at least was required to perform, these functions from 1982 until 1988. For the most part, loans which UES serviced during this time came from one source, the California Student Loan Finance Corporation. It is clear from the staff's investigation that as the size and number of portfolios serviced by UES grew, the company became less and less able to perform the required functions of a servicer. What had started out, in the words of some employees, as a "mom and pop operation," became in a short period of time one of the larger servicers in the country. Unfortunately, it did so without the benefit of an adequately sized staff, without the benefit of an adequately trained staff, without the benefit of adequate computer and other support systems, and without the benefit of adequate internal controls or procedures. As a result, UES failed to perform many of the required functions of a servicer, and it appears steps were taken to cover up the fact that these functions had not been performed.

UES employees. Almost every former UES employee the staff interviewed states that the UES staff was inadequate to perform the task assigned to it. To summarize, this includes: there was an ever increasing portfolio of loans that lead to a tremendous backlog of work; there was only one employee assigned to process guarantee agency claims that needed to be cured; at one point there was a 2-year backlog of mail that had never been processed; the training program for the staff was inadequate; important documentation such as promissory notes and loan applications were lost; and borrower payments were not processed in a timely manner.

Systems. The problems caused by inadequacies of the UES staff were compounded by the inadequacies of its computer and other automated systems. For example, a computer staff for loan servicing was not hired until the mid-1980s, computer conversions were frequently needed, and in 1987 such a conversion had disastrous results. The system never reflected what had actually happened with an account. Instead, it reflected what was supposed to happen. And fourth, the system was just incapable of performing certain tasks which then forced the staff to manually address them.

As problems with UES' servicing operations mounted, the reaction among supervisors seemed to be to attempt to take whatever shortcuts were necessary, including the falsification of records, to get the accounts out the door rather than stopping to deal with the problems at hand. This includes: collection histories were padded; claim packets lacking appropriate documentation or due diligence were forwarded to guarantee agencies without any attempt to rectify the problems therein; postage meter machines were back-dated to meet due diligence deadlines; and two computer programs, FIX and COMFIX, were used to insert after the fact false entries of due diligence activities into the borrowers' collection histories.

It appears that UES engaged in widespread activity to mask its inability to properly service its loan portfolios, activity which in some instances involved outright falsification of documentation, and yet no one but the line level employees admitted to the staff that they were aware of the actions that were being taken.

Senator **NUNN**. Is anybody under criminal investigation in UES?

Mr. **BUCKLEY**. Yes, they are. The FBI and IG are jointly conducting an investigation. We are critical of that investigation. The IG only has one agent assigned, and that agent has been pulled off several times to work other cases at other lenders or schools.

Senator **NUNN**. What is the FBI doing? Have they got agents assigned?

Mr. **BUCKLEY**. They have one agent assigned, and they are doing nothing actively. I think they just every once in a while will attend an interview with the IG agent. It is minimal at best.

Ms. **MCPHEARSON**. Although according to many of the employees with whom we spoke, UES experienced major problems for a number of years, these problems never seemed to have been detected by various outside auditors who examined UES' operation over the years. They do not seem to have raised any major concerns among the auditors as to UES' ability to continue to perform as a servicing company.

Senator **NUNN**. What concerns should the auditors and others looking at this have had?

Ms. **MCPHEARSON**. It was apparently quite obvious that there was a backlog of work there. We have been told that there were just stacks and stacks of mail that had never been dealt with. Obviously, the computer systems couldn't handle the work that was there to be done. And the audits were conducted, but mostly they were conducted by staff that CSLFC had hired, and they did not detect any of these problems.

Some of this could have been that UES attempted to hide the problems. We have heard that when they found out staff from CSLFC was coming over, they would literally shove packets of work into desk drawers and into back rooms to hide the fact that the work wasn't being done.

Senator **NUNN**. How about the inherent problem of basically being a lender to themselves? Actually they were originating loans and they were also running schools, weren't they?

Ms. **MCPHEARSON**. Yes, sir. In some cases there is nothing wrong with that, but there is a specific aspect of the law that says, I believe it is, correspondence schools cannot—UES in its correspondence school could not originate loans to those specific students. It wouldn't apply to all of UES' students. We have submitted for an exhibit something you might want to look at. Mr. Cohen had checked with the Department of Education to see if this was allowed. I have a letter signed by Jack Keefe of the Department of Education that Aaron Cohen wrote addressing this issue. We question whether Mr. Keefe interpreted that letter in the same way that Aaron Cohen had intended it. So, in a word, the Department did okay such activity, but we are not sure if the meaning is the same as it appears.

Auditors working for CSLFC reviewed UES' operations on a yearly basis while CSAC reviewed the operations biennially. Neither of these raised serious questions as to UES' overall ability to perform. Not until a joint audit conducted by the Department of Education, CSAC and HEAF in 1988 was the servicer's true performance noted. In June of 1988, HEAF stopped paying all claims on UES serviced loans. CSAC followed suit the following month.

This finally concludes our testimony regarding this complex incident. The performance for program participants and the Department of Education in this and other matters has not been encouraging. Over the next several months, the staff will be working on a number of recommendations. We will be happy to answer any questions you may have.

Senator **Nunn**. Just a couple of questions, you have got a very thorough report here.

Did you ask any other authorities to review the California State Banking Department reviews of FITCO?

Mr. **Buckley**. Mr. Chairman, we had two other Federal agencies with experience in banking oversight and enforcement review the State Banking Department's reviews of FITCO, and both of them said, that had these been their findings, they would have most likely have taken action—as early as 1982, or at least by 1983.

Senator **Nunn**. Well, who failed to take action then? Does that mean the Department of Education should have taken action, or did they have access to these California Banking findings?

Mr. **Buckley**. It is our understandings that the Department of Education did not have access to those files, and it is our understanding they do not want access to such information today.

Senator **Nunn**. They do not want access? Why?

Mr. **Buckley**. We asked the personnel at the Department headquarters here, giving this as a case example, that significant findings were made by State banking regulators and would it be helpful if, through Federal legislation, we gave them access, at least open the door so if they wanted to go in and look and see what FDIC or FSLIC or the State Banking Department had found relative to the business transactions of an individual bank or lender would be. They said no, they have got enough to do already, and more pointedly, that they wouldn't understand what they were reading anyway.

Senator **Nunn**. Did they ever think about getting somebody on the payroll that would understand what they were reading and looking at them? Did you talk to them about that?

Mr. **Buckley**. No, I didn't address that, sir. It seems like it would be an obvious solution.

Senator **Nunn**. Were there any indications that FITCO misled the investors of the trust rate accounts beyond what we have already seen here?

Mr. **Buckley**. Yes. We have appended to the statement several other examples of the advertising that FITCO used, and I think that Greg Voelm will testify to that directly tomorrow.

Senator **Nunn**. Who permitted FITCO to participate in the NDSL and the FISL loan program initially?

Mr. **Buckley**. There are indications in the early reports that FITCO was an NDSL/FISL lender, and if that is true, the Department of Education initially permitted FITCO to participate in the guaranteed student loan programs. I don't know if Mr. Kipp can address this from the California Guarantee Agency or not. That may have been FITCO's initial opening door. All the documentation that we have received, with the exception of one or two references, indicates that CSAC let them in with their first lender identification number to participate in these Stafford, PLUS, and SLS programs. But it also appears that the Department may have let them into FISL, and therefore that was carte blanche for CSAC.

Senator **Nunn**. Mr. Crissman, GAO's analysis of FITCO's filings of forms 799 and subsequent payment of origination fees indicated that this was a chronic problem for FITCO. Did the Department of Education know about these problems as they were occurring?

Mr. **Crissman**. Yes. There was some reference in some of the documentation that we obtained that even people in Region IX in the Department recommended a monitoring system of the submission of the 799 forms by FITCO going back to around 1987.

Senator **Nunn**. So what happened?

Mr. Crissman. That's a good question, Senator. I think that is something you would probably like to ask the Department, because it seems like even though they were paying closer attention, there was still nonpayment of these fees.

Senator **Nunn**. So nothing happened?

Mr. Crissman. Not that we are aware of.

Senator **Nunn**. Okay. Thank you very much. We appreciate your testimony and your hard work.

Our next panel is Richard Fulp, who is the Executive Vice President, Corporate Trust Accounts Division, Bank of America; Mr. Garry Hays, President, and Wendie J. Doyle, Assistant Vice President, Higher Education Assistance Foundation, HEAF; and Dr. Samuel M. Kipp, III, Executive Director, and Sydney P. Jamison, Associate Managing Auditor, California Student Aid Commission.

I will ask all of you to take the oath here if you would. Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth so help you God?

Mr. **Fulp**. I do.

Dr. **Kipp**. I do.

Ms. **Jamison**. I do.

Mr. **Hays**. I do.

Ms. **Doyle**. I do.

Senator **Nunn**. Mr. Richard Fulp is the Executive Vice President of Bank of America. Mr. Fulp will testify on behalf of the Bank of America regarding its involvement with the California Student Loan Finance Corporation. The bank has also provided testimony about its role as a participating lender in the guaranteed student loan program. I realize this matter is being litigated rather heavily and I understand there may be some areas that are sensitive from that perspective, but we hope we will be able to paint a complete picture of exactly what went on in California with this sizable portfolio of student loans.

Mr. Garry Hays is the President of the Higher Education Assistance Foundation. HEAF, as we know, is the largest single guarantor of student loans in the Nation. Mr. Hays is accompanied by Wendie Doyle, HEAF's Assistant Vice President for Compliance. Dr. Sam Kipp is the Executive Director of the California Guarantee Agency, California Student Aid Commission, and Dr. Kipp is joined by Sidney Jamison of the compliance team.

Mr. Fulp, we will hear from you first this morning.

TESTIMONY OF RICHARD FULP, EXECUTIVE VICE PRESIDENT, CORPORATE TRUST ACCOUNTS DIVISION, BANK OF AMERICA [1]

Mr. FULP. As you have indicated, I am an Executive Vice President of Bank of America National Trust and Savings Association, and I am responsible for the bank's Trust and Financial Management Services Division.

I am pleased to appear before the Subcommittee today to provide Bank of America's perspective on problems in the student loan program. As you probably know, Bank of America is the largest originating lender of student loans in California, and one of the largest in the country.

I have previously submitted with my written submission some information regarding our originating lender activity.

Senator NUNN. That will be made part of the record without objection.

Mr. FULP. I am testifying today on behalf of Bank of America though in another role. In addition to acting as an originating lender, Bank of America has also since the early 1980s served as an indenture trustee for the secondary market for student loans created and managed by the California Student Loan Finance Corporation, or CSLFC.

The CSLFC secondary market was started in 1980 and grew steadily throughout the 1980s. And at its peak in 1988, CSLFC's portfolio contained over $1.6 billion in student loans and represented the second largest secondary market for student loans in the country. CSLFC purchased loans from a variety of lenders, both in California and elsewhere in the country. Each of these lenders qualified as an eligible lender under Department of Education regulations. CSLFC loans went to students attending a wide variety of post-secondary schools, again, both in California and elsewhere around the country. The largest portion of the CSLFC loans have gone to students attending trade schools, each of which was licensed, accredited by an appropriate accrediting body, and certified by the Department of Education as eligible for participation in the loan program.

Bank of America acts as trustee for the CSLFC portfolio. Its duties, as defined in the relevant contracts, are typical of the duties of other secondary market trustees. They involve primarily accounting for the monies of the indenture estates. For example, the bank receives the funds due to the indenture estates and applies them as directed in the applicable indenture agreements, and it pays administrative and other expenses from funds available in appropriate indenture accounts as directed by CSLFC.

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[1] See p. 237 for Mr. Fulp's prepared statement.

In addition, because CSLFC does not qualify under the Higher Education Act as an eligible lender permitted to hold guaranteed student loans, Bank of America serves as eligible lender, holding nominal legal title to the student loans on behalf of CSLFC. In this role, the bank did not maintain possession of the loan files or have any contact with the student borrowers or otherwise service the loans. The outside servicing company performed these duties, and CSLFC oversaw the servicing operations with the assistance of its auditors. Nor did Bank of America as trustee deal directly with the Department of Education or the guarantee agencies regarding management of the CSLFC indentures.

The secondary market managed by CSLFC has been experiencing significant problems. As you know, these problems have resulted in an unprecedented and unfounded lawsuit against Bank of America by 10 of the world's largest banks, most of them foreign. These banks provided letters of credit to support CSLFC's financing. The banks are seeking to impose on Bank of America retrospectively duties and responsibility it simply does not have.

Today I will discuss the 3 major problems facing the CSLFC secondary market, although I will note that much of the information I will share with you today, Bank of America has learned recently through work performed outside of its normal role as trustee. The three problems I will discuss are, first, the improper lending practices by FITCO, or First Independent Trust Company; second, the servicing failures at UES, or United Education and Software, which was the major servicer of loans hired by CSLFC; and third, the potential impact on The California market of HEAF's current financial crisis.

Bank of America did not create any of these problems. Rather, Bank of America has already been a victim of the problems at UES and FITCO, and is concerned that HEAF's financial condition may compound these problems. The first problem affecting the California market involves FITCO, a financial institution which, as has been noted today, was headquartered in Sacramento, California. FITCO qualified as an eligible lender for participating in the student loan program. FITCO, which is now insolvent, made guaranteed loans almost exclusively to students attending trade schools within California.

During 1987 and early 1988, FITCO sold large numbers of its students loans to the CSLFC indenture estates. Under the relevant agreements, decisions to buy loans were made by CSLFC. Bank of America played only a ministerial role in these transactions. CSLFC decided what loans to buy and what lenders to buy from, and negotiated the price and other terms of the purchase.

Senator NUNN. What was Bank of America doing in all of this? Were you just basically lending your name?

Mr. FULP. Our role as trustee, as I mentioned earlier, was to do the receipt and disbursement of funds as far as the trust estates are concerned. Our role as eligible lender, which we assumed because CSLFC could not serve in that role, was simply to hold title to the loans. We had actually no physical possession of the loans.

Senator NUNN. So what purpose did you serve beyond having your name involved?

Mr. FULP. As a true trustee, we look after the interests of the bond holders, the bond purchasers, the indenture purchasers. And we do the basic what I would call big picture accounting as far as receipt of funds and disbursement of funds. We do not get involved in the actual loans themselves. The money received is primarily received from the servicer.

As I indicated, CSLFC decided what loans to buy and what lenders to buy from, and negotiated the price and the terms of the purchase. When CSLFC decided to purchase loans, it directed Bank of America as trustee to execute that purchase through written purchase instructions. Bank of America had no dealings at all with FITCO prior to the time the problems arose. It was only after the problems arose that Bank of America learned about the FITCO practices and the resulting problems.

The problems in FITCO's lending practices include two areas of substantial concern. First, FITCO failed to pay the loan origination fee due the Department of Education and the guarantee fee due the guarantee agencies on a large number of its students loans and falsely certified to CSLFC that these fees had been paid. Second, FITCO failed to report that some students left school early enough to avoid some or all of their tuition payments, with their loans canceled or refunded and the proceeds being returned to FITCO. Some of the loans purchased by CSLFC have been canceled or refunded in this manner, but FITCO kept the loan proceeds instead of reimbursing CSLFC.

FITCO's practices have caused losses to CSLFC——

Senator NUNN. Do you consider that basically fraud? Negligence? Where do you put that on the scale?

Mr. FULP. It is our position that their actions were intentional, but because of the litigation I just don't feel comfortable in commenting on whether there was actually fraud.

Senator NUNN. They knew what they were doing, in other words?

Mr. FULP. That's correct. We believe they knew what they were doing.

FITCO's practices have caused losses to CSLFC indenture estates. CSLFC and the letter-of-credit banks have been negotiating with FITCO's liquidator, the California State Banking Commission in an attempt to reconcile FITCO's accounts and resolve some of the problems caused by its lending practices.

The next problem facing the CSLFC secondary market involves the servicing problems at UES, United Education and Software. These problems were in large part the result of changing conditions affecting the student loan program nationally. As members of the Subcommittee are aware, in the early years of the student loan program most loans went to students at 2-year and 4-year schools. In the mid-1980s, this pattern began to shift as an increasing volume of loans were made to students attending trade schools who tend to default at a much higher rate than students attending 4-year institutions. By the second half of the 1980s, loans to trade school students began defaulting in record numbers. At the same time, the Department of Education was imposing stricter due diligence requirements on lenders and loan servicers.

In March 1987, new Federal regulations became effective that prescribed specific collection efforts, known as due diligence activities, to be taken when a borrower misses a loan payment. Thereafter the Department began strictly enforcing these technical due diligence requirements. Many loan servicers had difficulties complying with the due diligence requirements until at least early 1988 when the Department adopted new procedures to allow due diligence violations to be cured.

This was the environment in which UES servicing difficulties arose. By late 1987, these changing conditions in the student loan program were putting a severe strain upon UES capabilities to adequately service student loans. In particular, the size of the portfolio of loans serviced by UES was growing rapidly. A rising percentage of student borrowers were becoming delinquent on their loans, and the new Federal regulations were increasing the level and complexity of collection activities required at UES. UES simply couldn't keep up with this growing work load. These problems were exacerbated by a relocation to new premises and a badly flawed computer conversion UES attempted on its own in 1987 in an effort to keep pace with increasing demands. The result was a serious breakdown in UES servicing activities that affected a sizable portion of the portfolio.

In June 1988, the Department of Education, together with HEAF, conducted a review of UES activities. In July, the Department disclosed the preliminary results of the review, which reported serious deficiencies. The Department began working with CSLFC to remedy the problems uncovered.

In late July, Bank of America was notified of the problem. This was the first indication to Bank of America of the UES servicing failure and, in fact, the first time the Department or the guarantee agencies had contacted Bank of America for any reason concerning servicing of the CSLFC portfolio. After Bank of America was informed of the UES problems, it took steps to protect the assets of the indentures and minimize the losses that UES failures would cause. All the parties to the CSLFC indentures determined, and the Department of Education concurred, that UES could not continue to service the portfolio. Bank of America, CSLFC, and the other parties took steps to replace UES in order to ensure that the student loans were properly serviced.

Despite the continuing efforts of Bank of America and the other parties, the UES servicing problems have created huge costs for the indenture estates, which may amount to hundreds of millions of dollars. And these already enormous losses may be magnified by HEAF's current problems, the issue to which I now turn.

HEAF is the guarantor for approximately $560 million in CSLFC student loans, and over $9 billion in student loans nationwide. HEAF's current difficulties have been well publicized and I need not describe them here. Suffice it to say that HEAF now apparently lacks the financial ability to meet its guarantee commitments. This situation has placed in jeopardy HEAF's guarantee on over $300 million in CSLFC loans. As you would expect, Bank of America and the other parties to the indenture estates are monitoring closely the Department of Education's intensive efforts to resolve the HEAF crisis. The Department has assured Bank of America that it will in the near future develop a solution that preserves the integrity of the HEAF guarantee and treats all participants in the program equitably.

We are pleased to see recent press reports indicating that a solution is imminent and we remain optimistic that the Department will be able to fulfill its pledges.

In conclusion, Bank of America is——

Senator NUNN. What do you consider the Government's obligation here? You mentioned pledges and so forth. What are the pledges and what is it that you are looking to the Government to do?

Mr. FULP. Well, first of all, we feel that the Department of Education has a role in providing a financial solution to HEAF's problems. Secondly——

Senator NUNN. You think the Department of Education is implicitly or explicitly guaranteed to back up the HEAF obligations to the lenders?

Mr. FULP. I really cannot answer that from a technical point of view. I just am not qualified to answer that question. On the other hand, I believe all participants are looking to the Department of Education for a solution to a major problem which all of us are facing.

Senator NUNN. You don't have an answer to the question of whether you believe the Government is backing up HEAF?

Mr. FULP. The only answer I have to that is just to indicate to you, as you probably know, that the Department of Education has stated that they are going to step in and going to provide a solution to this problem.

Senator NUNN. The solution, does that necessarily mean backing HEAF up 100 percent?

Mr. FULP. Well, I am not sure it means backing it up 100 percent, but certainly some—as I understand the financial situation at HEAF—that some sort of backing is going to be essential for the problem to be resolved.

Senator NUNN. Okay.

Mr. FULP. In conclusion, Bank of America is encouraged to see that the Congress and the Department of Education are closely reviewing the student loan program in general. The current scrutiny can only result in a stronger, more stable program. As members of this Subcommittee grapple with these issues and develop recommendations, I urge you to bear in mind the important role played by secondary markets, like the one managed by CSLFC, in making large amounts of private capital available for student loans.

Mr. Chairman, that concludes my remarks. I thank you for the opportunity to present Bank of America's views to the Subcommittee. And I ask that a copy of the written statement we have prepared discussing these issues in more detail be included in the record.

Senator NUNN. Without objection it will be.

Mr. Hays, I think you are next, and then we will go to Dr. Kipp.

TESTIMONY OF GARRY HAYS, PRESIDENT, HIGHER EDUCATION ASSISTANCE FOUNDATION,[1] ACCOMPANIED BY WENDIE J. DOYLE, ASSISTANT VICE PRESIDENT

Mr. HAYS. Thank you, Mr. Chairman. I am Garry Hays, President of the Higher Education Assistance Foundation, and I am accompanied by Ms. Wendie Doyle, Assistant Vice President and head of our compliance area. I also prepared a formal statement that I respectfully request be entered into the record, and will summarize it very briefly for you.

Senator NUNN. Without objection it will be in the record.

Mr. HAYS. Our formal statement responds to your request for a brief background of the Higher Education Assistance Foundation, an account of HEAF's involvement with problems involving First Independent Trust and related organizations, and finally, an update on the status of HEAF's recently publicized financial situation.

Before addressing these topics, Mr. Chairman, I feel compelled to respond to Mr. Tommy Wayne Downs' misleading testimony before the Subcommittee on September 13th. HEAF Chairman Richard Hawk has written to you a letter which describes the diligence of HEAF personnel in discovering and submitting evidence with regard to this matter, and I would respectfully request that that letter be made a part of the record.[2]

Senator NUNN. Without objection.

Mr. HAYS. The Higher Education Assistance Foundation is a private nonprofit corporation that insures lenders against losses from default, disability, bankruptcy and death of student loan borrowers. HEAF was chartered in Minnesota in 1976, and since its inception has insured in excess of $15 billion in loans made to over 6 million students. Today its outstanding portfolio of insured loans is approximately $9.6 billion.

As an insurer of loans, HEAF purchases defaulted loans from lenders. Before paying a claim, HEAF examines the lender's collection efforts. During the current fiscal year, HEAF has examined more than $1 billion of insurance claims, rejected or refused to pay $125 million of such claims, and has imposed $9 million of interest penalties on lenders for violation of due diligence standards.

HEAF also reviews schools and lenders to assure compliance with the law in administering the loan program. During the last 24 months, HEAF's compliance department has conducted 207 program reviews, 120 of which were of schools, and 87 of which were of lenders. As a result of these reviews, HEAF undertook direct action against 49 schools and lenders, and recommended that the Department end the participation of 10 schools in the guaranteed student loan program. A total of $3.9 million has been collected from schools and lenders for payment of HEAF-identified liabilities and refunded to students and to the Federal Government.

HEAF also aggressively and effectively pursues students whose defaulted loans it has purchased from lenders. During this fiscal year for example, HEAF will refer over 500,000 accounts to 12 collection agencies, and will refer over 700,000 accounts to the IRS to obtain current addresses and for the purpose of withholding tax refunds. HEAF's own 203 collectors will place over 2 million phone calls and send 1.2 million collection letters to defaulted and to delinquent borrowers. As a result, HEAF will collect approximately $105 million this year from defaulted borrowers, and will on any given day be litigating over 12,000 cases using law firms throughout the United States.

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[1] See p. 282 for Mr. Hays' prepared statement.

[2] See Exhibit No. 36.

The particular situation, Mr. Chairman, Ms. Doyle and I have been invited to address obviously represents the largest operational and administrative failure in the history of the student loan program. It clearly involved a number of entities which engaged in practices that led to the loss of millions of dollars and resulted in hardship for students and for investors. You have already heard from at least two previous witnesses an account of the various players, the various organizations in this episode, and I will not repeat that. I will indicate that with regard to First Independent Trust and HEAF's involvement with First Independent Trust, the loan volume guaranteed by HEAF grew from $1.4 million in 1988 to $299 million in fiscal year 1988. Of the approximately 350,000 loans that FITCO made with the HEAF guarantee, totaling over $560 million, $547 million of that 560, or 97.7 percent, went to students attending proprietary schools. Such loans typically have a cancellation rate in excess of 30 percent, and they default at a rate of at least four times that of students attending 4-year colleges and universities.

You have heard an account of the role of the California Student Loan Finance Corporation and Bank of America as trustee for that arrangement.

In 1987, UES entered into an arrangement also to originate loans for FITCO. This meant that applications were sent to UES, which would examine the applications for eligibility information and would write the loan checks on behalf of FITCO and send them to the students attending their schools. Under this arrangement, UES originated nearly $26 million on behalf of FITCO, 97 percent of which went to students enrolled in UES schools.

Between March 1987 and March——

Senator NUNN. On that, do you believe that is a violation of any rule, regulation, or law?

Mr. HAYS. Mr. Chairman, I agree with Ms. McPhearson's answer initially that no, in and of itself it is not a violation.

Senator NUNN. Should it be?

Mr. HAYS. Perhaps there ought to be a number of safeguards under which such an arrangement should be able to occur.

Between March 1987 and March 1988, claims submitted to HEAF by UES failed in almost every instance to meet due diligence requirements, and they were rejected by HEAF and returned to UES, raising the prospect of large scale losses for the California Student Loan Finance Corporation, Bank of America, and the letter-of-credit banks. These losses were avoided, or made avoidable, in March 1988 when the Department issued its so-called "Cure Bulletin," which provided appropriate relief for inadvertent errors made under good faith efforts by lenders to service loans. But the effect in this case also was that it permitted UES to resubmit all of the claims which HEAF had previously denied. Thus, in April 1988, HEAF started receiving large numbers of resubmitted insurance claims from UES, and under the new procedures we began reviewing these claims in detail.

For reasons cited in my written testimony, Mr. Chairman, HEAF suspected serious deficiencies, and to prevent further payment of claims until these concerns were investigated, HEAF notified the Department and the Inspector General's Office about the suspected problems. In June 1988, two members of HEAF's compliance staff, headed by Ms. Doyle, and a special agent from the Inspector General's Office, conducted an on-site review of UES. This 4-day review uncovered serious irregularities in the loan servicing being done by UES. HEAF immediately at that point notified the Department that it was suspending claim payments to UES, and 3 weeks later the Department notified other guarantee agencies that it would no longer pay reinsurance on any loans serviced by UES.

I will not, Mr. Chairman, repeat the findings of that review. We have provided that information to your staff and to Mr. Crissman, and I agree with the characterization of those findings that Ms. McPhearson gave to you in the previous testimony.

During the months immediately following the review, and through subsequent investigations that took place, many more problems were identified in the UES servicing of loans. And in 1989, as you have heard, it was disclosed by Bank of America that the computer tape at UES contained computer programs the sole purpose of which was to falsify collection records to make it appear that required due diligence had been performed. By the time this discovery was made, millions of dollars had already been paid in claims based an collection histories containing these falsified entries.

The actions of FITCO which ultimately led to its seizure by the California Banking Department are no less egregious. Again we have provided the results of a review which we conducted in April of 1989 of FITCO to your staff and to Mr. Crissman, and again I agree with the characterization which you have heard this morning of those findings. I would note one item with regard to the nonpayment of guarantee fees. You heard about the nonpayment of origination fees, and the nonpayment of guarantee fees was also mentioned. As with the origination fees, FITCO withheld the guarantee fees from the borrower's loan proceeds and was reimbursed for such fees when the loans were sold. Despite extensive efforts to collect past due fees, and the granting of several extensions requested by FITCO, so it could reconcile its books with other secondary markets, FITCO failed to pay a significant portion of these past due fees. Consequently, on May 11, 1989, HEAF canceled the guarantees on approximately $60 million of loans for the nonpayment of these past fees.

The examination of FITCO's banking and accounting records also indicated that FITCO was commingling funds that it held in various capacities into a single account, to the serious detriment of students.

As a result of the foregoing and of the findings that you have heard in greater detail from your staff, CSLFC was faced with holding a massive student loan portfolio which had been declared uninsured by the several guarantors and unreinsured by the Department. Interest and special allowance were also suspended by the Department, effectively terminating revenue flow to CSLFC.

As a consequence of these events, CSLFC's trustee, Bank of America, and the various letter-of-credit banks, faced the likelihood of sizable financial losses. As a result, negotiations involving Bank of America, the letter-of-credit banks, the Department, and the three guarantors involved began in the fall of 1988, and subsequently evolved into two separate sets of negotiations. Bank of America was dealing directly with the Department of Education and was also negotiating with HEAF. In the course of its negotiations with the Department, Bank of America was able to secure certain concessions which enabled it to restore reinsurance for most of the loans in the CSLFC portfolio, as well as avoid the normal consequences for missing documentation and other shortcomings in the servicing of these loans.

With some exceptions, the net result was that due diligence violations of UES could be cured in the same manner as inadvertent servicing errors made by other lenders who were exercising good faith efforts to comply with the rigorous requirements of due diligence. Once the cure had been performed, regardless of the borrower's subsequent behavior, the reinsurance on the loan was reinstated. The insurance, however, was still void under HEAF's policy, which disallows cures in instances of fraud or in instances of severe and excessive due diligence violations.

In June 1990, HEAF and Bank of America arrived at a tentative settlement in which HEAF acquiesced to the concessions Bank of America by the Department of Education. That settlement, however, was explicitly predicated upon HEAF being able to secure from the Department of Education a plan under which HEAF would not have to bear the extraordinary costs from a portfolio that is so severely damaged by servicing errors that the default rate is projected to be at least 75 percent. On a portfolio of $560 million, this represents a potential cost which HEAF simply cannot absorb.

Senator NUNN. How much would the potential loss be?

Mr. HAYS. Given these projected default rates—and they are based on the delinquency rates that now exist—$85 million would be HEAF's cost after any reinsurance was paid.

Senator NUNN. What kind of resources does HEAF have now against that kind of loss?

Mr. HAYS. Against that kind of loss, Mr. Chairman, we do not have the resources to cover that loss, and that has been the reason for our ongoing discussions and for going to the Department with a tentative settlement only with Bank of America, that settlement being contingent upon being able to achieve some relief for the extraordinary costs we did not create.

Senator NUNN. What is the potential of taxpayer loss here?

Mr. HAYS. I suppose, Mr. Chairman, at a minimum the $560 million, for the HEAF portion, and CSAC has guaranteed another portion.

Senator NUNN. That's $560 million out of how much?

Mr. HAYS. The total portfolio I think was about $1.1 billion of the FITCO/UES serviced portfolio.

Senator NUNN. Dr. Kipp, could you answer that question for your organization?

Dr. KIPP. Well, I think the answer depends on the question you are asking, if you are asking to what extent are there additional taxpayer costs for dealing with the loans that we guaranteed in that portfolio above and beyond what there normally would be, the answer is there are none.

Senator NUNN. The answer is what?

Dr. KIPP. The answer is there are none from the portion that we guaranteed above and beyond what would be the normal default claim reinsurance cost of dealing with that portfolio and the defaults that are in it. In fact, if anything, because a significant portion requires cure and so far has not been cured by any party, at least a portion of those are loans that may well have otherwise defaulted will never be submitted for claim or eligible for reinsurance. In other words, no payments will be made by either the guarantee agency or in the form of reinsurance by the Federal Government on any uncurred delinquent loans.

Senator NUNN. Are you saying basically the loss was going to be so high anyway there is nothing additional, or what?

Dr. KIPP. No, I am only speaking of the loans that we guaranteed which don't have the same performance characteristics as the loans that Mr. Hays is describing.

Senator NUNN. Okay. Go ahead, Mr. Hays.

Mr. HAYS. At the present time, Mr. Chairman, because our concurrence was predicated upon getting relief for costs which we would not have borne under our own rules and regulations, without concessions that were granted to Bank of America, HEAF continues to refuse to honor claim requests for all but a limited number of Bank of America claims. The Department has asked HEAF to delay until September 30, 1990, the rejection of tens of thousands of claims that we have received from Bank of America's servicer. Absent further instructions or a resolution of this matter by that date, HEAF will have no choice but to reject those claims.

Senator NUNN. What date is that again?

Mr. HAYS. September 30th is the date that the extension granted by the Department of Education expires.

Senator NUNN. So unless something happens in the next 4 or 5 days you are going to turn down those?

Mr. HAYS. Right. There would either have to be, Mr. Chairman, a further extension of the requirement that is placed upon us to pay those claims within a 90-day period, or some other resolution.

Senator NUNN. And again, what amount of money are we talking about?

Mr. HAYS. In terms of the amount of claims that are likely to come in?

Senator NUNN. Yes.

Mr. HAYS. In terms of the claims that have already been submitted, Mr. Chairman, we are probably talking in terms of 40,000 to 50,000 claims that we are simply warehousing at this point. And the reason for that is that Bank of America has requested, pending the possibility of some resolution, that as we reject those claims, we simply not send them back, that we hold them. So we have been holding them. We have not been processing them. Some of those

40,000 to 50,000 claims would not be subject to the kinds of conditions that we have described here and would be payable, but because they all came in at once and Bank of America has preferred not to sort those out at this point, I don't know what that number is.

The potential liability sitting out there potentially to come in is that portfolio of $560 million, which, according to the so-called aging reports provided by Costa Mesa, the servicer on this portfolio, indicates a delinquency rate of running some 70 to 75 percent. So outside possibility, outside potential would be approximately 75 percent default rate on a portfolio of $560 million.

Senator NUNN. So you are talking about $400 million or $450 million. Out of that how much, Mr. Fulp, does Bank of America have exposure on?

Mr. FULP. Well, that is a matter, Mr. Chairman, that is in litigation currently, but it is the position of Bank of America that Bank of America itself does not have exposure.

Senator NUNN. Well, I am not saying whether you are going to end up paying it or not, I am saying what is the potential exposure if your lawsuit is not successful?

Mr. FULP. I am just unable at this time to give you a precise number, but we feel the exposure, even under the worse scenario, is lower than that number that has been given.

Senator NUNN. Lower than $400 million?

Mr. FULP. Yes.

Senator NUNN. Would it be fair to say between 200 and 400? Is that a general guess?

Mr. FULP. A general guess, yes.

Senator NUNN. Okay. Mr. Hays.

Mr. HAYS. Finally, Mr. Chairman, you asked that I comment on HEAF's status with regard to the well publicized financial problems. First of all, let me suggest that there exists an erroneous perception, fostered by public statements by some of our competitors and by certain officials in the Department of Education, that HEAF's problem was created because we recklessly attempted to capture the market of high risk trade and technical school loans. To the contrary, our written testimony which we have submitted to you documents in some detail our efforts between 1986 and 1988 to reduce our proprietary school volume, all of which such efforts were judged by the Department to be unallowable.

Finally, the Department agreed that we could withdraw from States altogether and thereby stop guaranteeing loans for high default schools in those States, and we did that in July 1988. While the portfolio mix is now running approximately——

Senator NUNN. In other words, you felt that you had gotten too deeply involved in this and you tried to start getting out, and you are saying the Department of Education wouldn't let you get out?

Mr. HAYS. Mr. Chairman, in 1986 we saw the growing trend of an imbalance, the beginning of an imbalance between 4-year loans and proprietary school loans. And for reasons that have been discussed and mentioned earlier this morning, because of the high default rate—the historical default rate on proprietary school loans which we have guaranteed has been running 47 percent historically, it is running closer to 60 percent in recent months—because of that, an imbalance obviously in the direction of proprietary school loans has serious and obvious financial implications for a guarantor. We weren't just sitting there blind to that. We saw that coming, we attempted to take some steps beginning in 1986, and particularly in 1987 and early 1988 to cause some of that volume not to continue to come to us for guarantee.

Senator NUNN. What year did you sign up and start handling a lot of FITCO's guarantees?

Mr. HAYS. 1986.

Senator NUNN. Didn't you realize then that they were about 97 percent proprietary?

Mr. HAYS. At that time, Mr. Chairman, I don't think we did know that they were that heavily proprietary. We had had no history with them prior to that time. Their experience had been primarily in the State of California—Dr. Kipp can correct me if I'm wrong—but where I think their portfolio was a bit more balanced than what their portfolio became as they became a national lender. It was at that point that FITCO apparently decided to expand outside of California and came looking for a national guarantor that was guaranteeing loans in a variety of States.

I might suggest also, Mr. Chairman, that when we did see what was happening with regard to the FITCO volume, and when we did see that it was running over 96 to 97 percent proprietary school loans, FITCO was one of the seven lenders whose lender agreement we attempted to terminate as a result of a provision in our agreement that says that we may terminate the agreement of a lender with 60 days notice. We attempted to do that.

Senator NUNN. You attempted to do that. Did you accomplish that or did you not accomplish that?

Mr. HAYS. Mr. Chairman, we did not accomplish that.

Senator NUNN. What kept you from terminating?

Mr. HAYS. Mr. Chairman, that was one of the actions which we attempted that the Department determined to be unallowable under its interpretation of the regulations.

Senator NUNN. They said you could not terminate?

Mr. HAYS. They indicated that, in their view, under the regulations the only way that a guarantor could terminate a lender was, quote, "for cause." That is, for violation of program rules and regulations.

Senator NUNN. And you didn't have——

Mr. HAYS. A high default rate is not a violation under the present rules and regulations or under present law.

Senator NUNN. And you couldn't find any other violations?

Mr. HAYS. At that time——

Senator NUNN. What time frame was this?

Mr. HAYS. This was late 1987.

Senator NUNN. At that time you didn't have any other violations to cite to the Department of Education, other than the high default rate?

Mr. HAYS. We did not, Mr. Chairman, at that time. We had not undertaken the review yet. The kinds of complaints that we started getting and the kinds of things that we started seeing from UES-serviced FITCO loans did not become apparent to us until the spring of June 1988.

While the portfolio mix, Mr. Chairman, on our loans now being currently guaranteed by HEAF is running approximately 73 percent 4-year paper and 20 percent proprietary school loans, the large volume of proprietary school loans which were guaranteed in 1987 and 1988 while we were negotiating with the Department of Education is still passing through that delinquency and default cycle.

Additionally, the resolution of the Bank of America portfolio in a manner that makes claims which were formerly ineligible for insurance and reinsurance to now be eligible represents, as I have indicated before, a huge additional burden on HEAF's reserves. When HEAF presented a plan for how the Bank of America settlement could be implemented without HEAF absorbing costs we would not otherwise have had, statements were made about HEAF's financial condition which turned what had been a manageable problem into a national crisis. We have been and we will continue to be cooperative with the Department of Education. We have indicated that to them. And we will be willing to look at any reasonable solution which the Department may recommend, hopefully within a matter of days, with regard to this matter.

Mr. Chairman, thank you, and we would be pleased to respond to any questions you might have.

Senator NUNN. Thank you, Mr. HAYS. Just one question, and then we will go to Dr. Kipp.

From the time you tried to terminate FITCO until FITCO went under and you basically didn't have any more loans—from the time, in other words, the Education Department said you could not terminate them—how much more exposure was there, both to you and to the Government? In other words, how many more loans did you make?

Mr. HAYS. Mr. Chairman, we have that in our written testimony, but if memory serves me correctly, it is about $500 million.

Senator NUNN. So there was an additional $500 million that was poured into this FITCO after you said to the Department of Education that they should be terminated because of the high default rate?

Mr. HAYS. Mr. Chairman, after we attempted to cancel and terminate the lender agreement that we had with FITCO, and frankly, some six other lenders as well.

Senator NUNN. And were you not able to terminate the other six lenders either?

Mr. HAYS. We were not able to terminate any of the lender agreements. Those seven lenders were bringing us on an annual basis approximately $1.5 billion in proprietary school loans.

Senator NUNN. Did the Department give you a reason as to why the regulations did not permit high default rates to enter into the determination of the guaranteeing agency?

Mr. HAYS. Mr. Chairman, that is not simply a Department regulation. The Higher Education Act as amended now explicitly states that a guarantor may not discriminate against a school based on default rate, type of institution, or length of academic program.

Senator NUNN. So it is not a matter of regulation, it is a matter of law then?

Mr. HAYS. With regard to the default issue, it is a matter of law.

Senator **Nunn**. Was that the case when they ruled against you?

Mr. **Hays**. Yes, it was, Mr. Chairman.

Senator **Nunn**. That is not a new law, that has been on the books?

Mr. **Hays**. Since 1986 I believe, Mr. Chairman.

Senator **Nunn**. Do you think that law is one that needs to be reviewed, or perhaps repealed? What do you suggest about that?

Mr. **Hays**. Mr. Chairman, with regard to those kinds of issues, it does seem we have in the law and in the public policy with regard to the intent of this program, a contradiction. The basic intent of the program, as you have heard here this morning, the basic philosophy has been to serve all populations, and particularly with regard to the changes which have moved away from the program being primarily for middle class parents to a program aimed at lower socioeconomic groups, and drawing from groups that are much more likely, frankly, to go to for-profit proprietary institutions.

You have the issue of accessibility on the one hand and on the other hand some limitations with regard to at least large guarantors like ourselves that were willing to guarantee and provide access, limitations on our ability to handle that financial risk; specifically, the maximum 3 percent guarantee fee and the particular reinsurance formula that now exists in law.

I am not certain that the default issue so much ought to be addressed with regard to subsequent kinds of controls and changes in the law, but I would suggest that there are some other things that impinge upon this issue very directly. We find among the major abuses when Ms. Doyle goes out to review schools, not so much specific violations of law and regulation, which we certainly can control and I think do have the authority to control. What we find are abuses with regard to educational quality, recruiting of students, false advertising or misleading advertising, the inability or the refusal to refund student loans when students drop out. We have, obviously——

Senator **Nunn**. Isn't that a violation of the law, the failure to make refund?

Mr. **Hays**. With regard to refunds we can take action on.

Senator **Nunn**. And false advertising is no violation of any law or regulation?

Mr. **Hays**. The educational issues, the misleading advertising, fall outside. They go more to the issue of eligibility and accreditation.

Senator **Nunn**. And you can't do anything about that?

Mr. **Hays**. We can call it to people's attention, but we have no authority to address it. And frankly, we have no expertise, should have no expertise necessarily as a guarantor, to address issues of educational quality.

Senator **Nunn**. But when it comes to your attention, do you then think it is your duty to bring it to someone else's attention, and if so, who do you notify?

Mr. **Hays**. May I ask Ms. Doyle to respond to that question?

Senator **Nunn**. Sure.

Ms. **Doyle**. When we find issues such as that that don't directly involve the financial aid administration of a school, we refer the problems to accrediting agencies. It may be noted in our review reports which are sent to the Department of Education.

Senator **NUNN**. You do notify the accrediting agencies then?

Ms. **DOYLE**. We have. We also——

Senator **NUNN**. Is it a matter of routine, or is that just a matter of every now and then?

Ms. **DOYLE**. We are not in a position routinely to come across these problems in order to quantify them and to make the determination.

Senator **NUNN**. But Mr. Hays said that is what you run into out there. It sounds like you do run into it a lot.

Ms. **DOYLE**. We run into it generally. That doesn't mean that we have specific advertisements, recruitment methods that we are able to document.

Senator **NUNN**. You know something is wrong though, right?

Ms. **DOYLE**. Yes.

Senator **NUNN**. And when you know something is wrong, do you have any instructions about what to do about it?

Ms. **DOYLE**. We refer the matter to appropriate agencies. We work very closely with the Inspector General's Office. But strictly what we do look and are charged with looking at during the program reviews is the administration of the loan programs.

Senator **NUNN**. Could you furnish for the record any kind of notifications you have given to either accrediting agencies, the IG, Department of Education, or State licensing bodies relating to the quality of education, misleading advertising, abusive practices, or anything that falls outside your scope to terminate?

Ms. **DOYLE**. We have a lot of correspondence in our files between such agencies and ourselves.

Senator **NUNN**. Could you furnish that for the record?

Ms. **DOYLE**. Sure. [1]

Senator **NUNN**. A reasonable amount. I am not asking for everything. I just want to see examples of it.

Mr. **HAYS**. Certainly.

Senator **NUNN**. Dr. Kipp.

TESTIMONY OF SAMUEL M. KIPP III, PH.D., EXECUTIVE DIRECTOR, CALIFORNIA STUDENT AID COMMISSION,[2] ACCOMPANIED BY SYDNEY P. JAMISON, ASSOCIATE MANAGEMENT AUDITOR, CALIFORNIA STUDENT AID COMMISSION

Dr. **KIPP**. Mr. Chairman, thank you for the opportunity to provide information that I hope will be of assistance to this Subcommittee in its investigations. I am joined here by Sydney Jamison, who is one of our key investigators and does reviews of lenders, servicers, and other major participants in the program.

I am Sam Kipp. As a past faculty member of a major university, I have observed first hand the hopes and dreams which compel many Americans to seek a better life through higher education. My later work as a higher education policy specialist reinforced my understanding of the important role which financial aid plays in making those dreams a reality.

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[1] See Exhibit No. 39.

[2] See p. 343 for Dr. Kipp's prepared statement.

My current position as Executive Director of the California Student Aid Commission has made me appreciate the tremendous contributions of our current grant and loan programs, but it has also made me all too familiar with the unfortunate plight of those students who are most frequently the victims of malfeasance when it occurs in the student loan program.

I have long advocated reforms which would eliminate the parasites which have attached themselves to an otherwise sound, healthy, and worthwhile student loan program. This is not just rhetoric. In California, whether the wrongdoing has been on the part of students, schools, or lenders, we have been willing to take the necessary compliance action. In the first month after I became director in 1986, we took an administrative action to terminate the first school ever removed from the California student loan program. Since then, 30 additional schools and one lender in the State have been limited, suspended or terminated from the program.

If that number appears modest, I would simply point out that it represents approximately half of all the termination actions that have been taken in the United States since the loan program began. Most of the violations were discovered during the Student Aid Commission's 140 annual program audits of schools and lenders. In every instance, the school removed from the program was a for-profit vocational school. The most frequently cited violations which established a continuing pattern of administrative failure on the part of the schools were that they were unable to make timely refunds, that they were certifying ineligible loans, and they were failing to establish the student's financial need or their ability to benefit prior to enrolling them.

Senator **Nunn**. If I could interrupt you here, we have had testimony from a number of people that at least implied strongly that these defaults, these kind of problems we are having with the proprietary schools and so forth, are just part of what the Government has to accept in trying to help low-income people get skilled training.

Do you agree with that basic premise, that we just have to accept this?

Dr. **Kipp**. I don't agree with the basic premise. I agree with the recognition that there is a certain portion of defaults that are inherent in the program, but I have never accepted the idea that the kinds of default rates that we are experiencing, whether they be in California or anywhere else, are the level that defines what that appropriate level is.

Senator **Nunn**. In other words, whatever that appropriate level of inevitability is, we are far above it?

Dr. **Kipp**. I believe so. I mentioned one lender that we sought to terminate which was once, as you know, one of the largest lenders in the Nation. He made $519 million in student loans that were guaranteed by us, and approximately a billion dollars in student loans guaranteed by others. FITCO was terminated by the Commission for failure to pay at least $4.5 million in loan origination fees that were owed to the Department, failure to make millions of dollars worth of timely refunds to borrowers, and other serious violations. Dozens of students, or more often those posing as students, as well as some school owners or officials who have attempted to defraud the program have been caught, directed to pay restitution, and often sent to jail because of the cases assembled by the Student Aid Commission's fraud investigators.

These actions have no doubt given rise to a "get tough" reputation for the California Student Aid Commission. That is the nicest way we are often described by some people. We don't mind the characterization at all. The Commission is committed to taking an aggressive, no nonsense approach to protecting students and to restoring public confidence in the integrity of the loan programs. The Commission makes no secret that during the past 5 years we have nearly tripled the size of our compliance staff, we have doubled the personnel assigned to investigations, and introduced a number of innovative steps to reduce defaults and to enhance program integrity.

These adjustments have been necessary in the face of a dramatically changing student loan program. And to better understand where we are today, I would like to briefly review some of the program dynamics that have been in place in the last 4 or 5 years.

Several factors set the stage for the unprecedented explosive growth in the volume of student loans during the late 1980s. Under the Higher Education Act Amendments of 1986, annual and aggregate student loan limits in both the Stafford and SLS program were increased. While demonstrated need and multiple disbursement somewhat tightened eligibility in the Stafford program, other provisions made the application process for the supplemental loan program extremely easy and attractive. Taken together, these factors combined to create an ideal vehicle for exponential growth in borrowing at vocational schools. This was further fueled by simultaneous growth in the national activities of multi-state guarantors, and by growing competition among student loan secondary markets.

Unfortunately, in this era of expansion, some smaller undercapitalized financial institutions extended their student lending well beyond their financial means and well beyond their administrative capabilities. Accompanying this growth in volume was a growing national concern over rising student loan defaults. But hearing a contradictory Congressional chorus which called for unlimited access to student loans and a curb to defaults, the Department of Education elected to view defaults as the product of reluctance on the part of lenders and guarantee agencies to diligently pursue student loan collections. This "defaulters as deadbeats" myth gave rise to a cumbersome, mechanical approach to due diligence collection requirements which failed to squarely face the real problems in the program. The vast majority of defaulters could not pay rather than would not pay. Furthermore, they could not pay because they were too often the victims of schools that failed to deliver the quality education and training and jobs that they had promised.

Senator NUNN. In other words, if in the very beginning the schools were legitimate schools that were striving to provide quality education, as they purported to be, then the default rate itself would come way down because the students would be doing a lot better. They would be more likely to remain in school and then when they got out they would be able to hold a job. Is that what you are saying?

Dr. KIPP. Senator, I believe all the evidence that we and others have assembled affirms that basic fact.

Senator NUNN. Is that the heart of the problem then? I know there are a lot of other problems, but would you say that is the fundamental flaw here?

Dr. KIPP. In my view it is. The fundamental issue is the school, the issue of school eligibility and educational performance.

Senator NUNN. You made one other point here that I think is important. You are saying basically that Congress is giving two signals. On the one hand, the signal is unlimited access, everybody has access. On the other hand, keep the default rate down. Are you saying one or the other has to go?

Dr. KIPP. I am saying that it is time for Congress to make up its mind what it wants or what kind of reasonable balance between those two factors it wants.

Senator NUNN. You are saying the law has tilted too far toward unlimited access, from your point of view?

Dr. KIPP. I think the focus has been too uncritically on access without asking the question of access to what. And it is my conviction that the promise of access, as I have said many times, to an institution that cannot or will not deliver the quality education or training that it promises is no benefit to anyone.

Senator NUNN. So you are saying that the problem is not that the law tilts too much to having eligibility for all students who want to go to school, you are saying the law's problem is it tilts much too strongly—or the way it is applied at least—to unlimited access for schools themselves to come in and provide very poor quality education. And basically their fundamental reason for existence is the student loan program and the generation of money. Is that what you are saying?

Dr. KIPP. That is basically my point, yes.

Senator NUNN. You are saying we don't have to yield on access to students, but the access of schools to be called schools and their eligibility to participate in the student loan program has got to be greatly restricted. Is that what you are saying?

Dr. KIPP. We owe everyone an opportunity to maximize their opportunities in life, and education is an ideal vehicle to do that. But at the same time that we offer that kind of opportunity through financial aid and through other programs, we also have a responsibility to make sure that the people who profess to provide that opportunity in fact deliver on what they promise.

Given this combination of circumstances, the stage was set for occasional disasters as well as to some ongoing structural problems: expanded loan limits; proliferation of low and no-quality schools established for the primary purpose of collecting student loan proceeds; intense national competition by some lenders and guarantors to accumulate loan volume with too little attention given to portfolio balance, to program compliance, or to school quality; and some secondary markets hungry to provide liquidity to lenders for whatever loans they could book as assets. Under these circumstances, the worst was bound to happen, and in California and in a few other places it did.

I won't repeat much of what you have already heard about the cycle of events and circumstances involving First Independent Trust company, the California Student Loan Finance Corporation and UES, but there are a couple of points that I would like to make in an abbreviated version of my written testimony, and I trust, as in the other cases, the full written testimony will be a part of the record.

Senator NUNN. Without objection it will be.

Dr. KIPP. First Independent Trust Company of Sacramento became lender, as you have heard, in the Federal guaranteed student loan program in 1980. Beginning in 1985, which I regard as sort of the second phase of its existence in the program, it ranked number 14 in terms of lending. Then, fueled by its own ambitions, by large forward purchase agreements from the California Student Loan Finance Corporation, the explosive demand for loans from out-of-state proprietary schools, and the ready availability of HEAF guarantees, tiny FITCO quickly rose to become one of the very largest originating lenders in the country by the late 1980s.

FITCO, as you have heard, did not hold its loans for very long after origination, selling them almost immediately to a secondary market. The vast majority were purchased by CSLFC. CSLFC had depended on UES for the servicing of their operations and, as you have also heard, a rather unique circumstance in this case is that in addition to providing origination services for FITCO and servicing on the loans, UES also operated a chain of proprietary schools within the State.

CSLFC sought and received an amendment to its original plan for doing business—I believe it was in 1986—to allow it to also purchase what it promised would be a small number of loans made to students outside the State of California. In fact, most of its dramatic growth after that date stemmed from the rapid acquisition of out-of-state loans, not California loans or California guaranteed loans.

This combination proved to be a formula for explosive, nearly unchecked, growth in FITCO loan origination for a brief period of years. A Commission compliance review in November 1987 resulted in the citation of FITCO for failure to pay over $13 million in loan origination fees that were owed to the Department. Also for failure to make timely refunds owed to students, and for other critical administrative errors. In the course of that review, there were subsequent meetings between Ms. Jamison and the Department, and after the Department was promised by FITCO that it would receive its $13 million, it was largely satisfied and didn't seem to want to press on anything else.

One of the things that she had uncovered also in the course of the review was the use or commingling of various funds in different accounts, and she explicitly asked the State Banking Department whether in fact that was illegal or not, and they said they didn't see a particular problem with it.

We have always shared our reviews of schools or lenders with Region IX of the Department of Education. Increasingly, we share our reviews of schools with the appropriate accrediting body, and we did so in these instances. In August 1988, a report based on the joint audit that has already been referenced by the Commission, by

HEAF, and by USDE, identified potentially some $600 million in student loans held by CSLFC which had been compromised severely by the faulty servicing provided by UES. The shockwaves of this tragic failure have reverberated through international credit markets, the operations of almost all secondary markets, lenders, and the entire student loan program.

The Commission conducted a follow-up compliance audit of FITCO in February 1989. It revealed serious problems, which included providing computers and software to schools as an incentive to process FITCO loans without consistently securing payments that were required so those wouldn't be considered inducements, the failure to pay additional millions of dollars in origination fees owed to USDE, to make timely refunds, or to notify current holders of its loan cancellations.

Based on this evidence of continuing administrative failure, the California Student Aid Commission terminated FITCO from the program on April 21, 1989. The California Banking Department seized FITCO on May 19, 1989, and initiated liquidation of the lender's assets.

The consequences of the FITCO/CSLFC/UES failure in which a corporation that owns and operates schools also originates loans for a lender, which in turn quickly sells those loans to a secondary market that has contracted with the same corporation to service its loans, had a profound impact on the student loan program. Costs for credit support for student loan secondary market bond issues were raised to reflect the great risks of student lending. Tighter restrictions on portfolio composition and secondary market purchases affected primary lending and led to more limited access to loans for students who wanted to attend certain schools.

The total financial losses, not yet fully known, are already staggering. But the greatest victims are the hundreds of thousands of students left with bad debts, bad credit ratings, and few if any marketable skills.

Having shared with you the details of the FITCO mess, I must emphasize that it is neither indicative nor representative of the student loan program as a whole. It would be a mistake to confuse the excesses of the program, which are very real, with its essence. The vast majority of student loan borrowers get good educations at quality institutions and are able and willing to repay their loans. Most lenders follow sound lending practices and adhere to program requirements. However, the day is long past for encouraging indiscriminate borrowing in the student loan program under the pretense of championing access. Congress must recognize, as we observed earlier, Senator, once and for all that access to anything less than a quality education is no benefit to anyone. The issue is not an issue of institutions that serve poor students. The issue and the problems in the program are with institutions that serve students poorly.

Guarantee agencies have a critical role to play. They must be willing to provide the services and oversight that are central to the daily operations and to the overall health of the loan program. They must be prepared to get tough and to take the necessary compliance action to uncover and eliminate fraud and abuse when and where it occurs. This will undoubtedly mean taking risks. If aggressive action to protect and improve the program will lead to an occasional time or another of being sued, then so be it. Of equal and perhaps greater importance, guarantee agencies need to work with their States, as well as with the Congress, to tighten the requirements, particularly the licensing requirements for vocational schools, to assure greater consumer protection.

Frankly, we became impatient in California, waiting for accrediting agencies to do something—and you have had in your own hearings evidence of the reasons for that kind of impatience.—We became impatient with the Department's certification process, and so we decided to try to take the matter into our own hands and to look at the third element in the equation, which was the State role of licensing institutions, and focus there on trying to assure not only adequate financial capability on the part of any institution that is allowed to operate in California, whether it is in the student loan program or not, but also to assure that there are adequate safeguards, truth in advertising, and sufficient protections for students and citizens as consumers within our State. That law has been passed. We are in the process now of enforcing it. It is too early to know how great its impact is going to be, but we think it will be substantial.

USDE must also take immediate steps to ensure that program requirements limit eligibility only to qualified educational institutions. Tightening eligibility requirements is far better than waiting for substandard schools to victimize more students. Tens of thousands of lives have already been damaged by inadequate eligibility standards. In the absence of effective Congressional or Departmental action, back-end compliance actions such as the ones I have described that we and others have undertaken are still essential, but they are not really a very satisfactory long-term solution.

The marketplace is also providing part of the correction. Secondary markets can no longer purchase or support unbalanced student loan portfolios. The financial margins in the loan program are too narrow and the risks and penalties too great for lenders to engage in open-door lending, or to originate too high a proportion of risky loans. And furthermore, lenders cannot afford to use guarantee agencies with portfolios that are seriously out of balance.

On a bright note, Congressional budget reconciliation in 1989 is already producing substantial benefits and dramatic program savings. Despite some misleading rhetoric about access, we should stay the course on those changes. Cut off from SLS funds, many bad schools are closing. As painful as that may appear to be for those students who are affected, this type of shake-out will ultimately benefit the program and students as a whole. It may narrow the choice that students have among institutions, but it will at least narrow it to institutions of higher quality and those with a better record of delivering the education and the training they promise.

There are also some so-called corrective steps which I recommend be avoided. There is no room to reduce special allowance payments and further narrow the margin of incentive for lenders to continue to participate in the program. There is no excuse for imposing even greater loan origination fees or guarantee fees on students. We need less emphasis on increasing the mechanical approach to due diligence, and more emphasis on performance. Nor can we insist that guarantors and lenders more carefully screen out ineffective schools with high default rates and at the same time continue to insist that guarantors also serve as a lender of last resort for schools that are so poor in quality that no participating lender will make them such loans.

Circumstances surrounding the loan program have changed so dramatically that I doubt that we will have a repeat of the FITCO experience. Market corrections, measures by Congress, actions by guarantors and others, have produced a higher set of expectations for the future. These were much needed, I might add. However, it is essential that the existing checks and balances of the educational loan program be maintained, if not dramatically strengthened. We must not allow a repeat of the lender/school/secondary market servicer loop which wreaked so much havoc in the program in this instance.

I believe there are several other vital lessons which can be drawn from the program's experiences, both the good and the bad that have occurred in recent years. As a guide, it is clear that genuine educational opportunity requires access to quality education and training. It is also clear that the student loan program provides nearly half of all the financial aid funds available for such purposes, and does so in a reasonably cost effective manner. Although significant reforms remain to be carried out, the basic structure of the program is sound and should be preserved. Progress can be achieved, Senator, through continued investment of resources and a strong commitment by all parties.

I know that the California Student Aid Commission and many other dedicated program participants will continue to work to make sure that the guaranteed student loan program is a realistic means by which students and their families can fulfill their educational dreams.

This concludes my testimony. I would be happy to answer your questions.

Senator **Nunn**. Thank you very much, Dr. Kipp, Mr. Hays, Mr. Fulp. I have just a few questions here.

Mr. Fulp, what is the status of the lawsuit you are involved in now? Who are the parties and what is the status of it?

Mr. **Fulp**. Just a minute, let me speak to counsel.

The trial is scheduled for March 1992. The parties involved are all the letter-of-credit banks, both on-shore and offshore, Bank of America, the CSLFC auditors and—

Senator **Nunn**. Who is the plaintiff in the case?

Mr. **Fulp**. The letter-of-credit banks.

Senator **Nunn**. Who?

Mr. **Fulp**. The letter-of-credit banks.

Senator **Nunn**. Including Bank of America?

Mr. **Fulp**. No. Bank of America is the defendant. The letter-of-credit banks, I think there are a total of 10, of which they are predominantly Japanese banks.

Senator **Nunn**. Japanese banks. Why did the Japanese letter-of-credit banks enter the student loan market?

Mr. **Fulp**. Well, I can only speculate because I really don't have it from their perspective, but when they began to enter that market, that was a period in which they were domestically in

Japan operating in a very favorable regulatory environment. They were able to offer rates in the United States which were quite competitive, if not down right favorable, and there was a strong desire on the part of Japanese banks to do business within the United States.

Senator **Nunn**. Does the Bank of America service its own student loan portfolio?

Mr. **Fulp**. No we do not.

Senator **Nunn**. What has been your experience with outside loan servicing operations? Of course, we know about UES, but what about others?

Mr. **Fulp**. Excluding UES, the general experience has been satisfactory.

Senator **Nunn**. Did Bank of America ever have any direct dealings with the Department of Education regarding this overall matter before the UES situation was discovered?

Mr. **Fulp**. To the best of my knowledge, there were no direct dealings with the Department of Education prior to July 1988, other than just routine correspondence, notifications, that sort of thing.

Senator **Nunn**. Were you ever subject, Bank of America, to an Education Department review or audit?

Mr. **Fulp**. No we were not.

Senator **Nunn**. Mr. Hays, what is being done by the Department in response to the financial troubles at HEAF? What is the status of that?

Mr. **Hays**. Mr. Chairman, it has been widely reported that the Department is considering two options, one option involving the Student Loan Marketing Association, one option involving United Student Aid Funds. As of this time, if the Department has made a decision or a recommendation to OMB with regard to a decision, we are not aware of that. The Department has not shared with us at least what that decision is likely to be. We have, at the encouragement of the Department, had discussions with both Student Loan Marketing Association and with United Student Aid Funds. We are prepared to continue those discussions and to enter into appropriate negotiations once the Department has made its decision.

Senator **Nunn**. Mr. Hays, does HEAF have a write-off policy for students who are victims of lender fraud or victims of school fraud?

Ms. **Doyle**. We have a policy—we refer to it as our fraud policy—which has been approved by the Department of Education, which allows us in specific instances of documented fraud on behalf of the school or a lender to cease collection activity on the borrower, to remove the credit bureau reporting, and to seek reimbursement from the appropriate school.

Senator **Nunn**. And that's what you do?

Ms. **Doyle**. We do that for documented instances of fraud. If what you are referring to is a write-off policy for closed schools, no, we do not have an approved write-off policy at this point.

Senator **Nunn**. Shouldn't you?

Ms. **Doyle**. We would like to very much. In the past we have attempted to achieve a satisfactory write-off policy with the Department of Education. We have not been able to do so. The guidelines that they have issued, frankly, we have found to be operationally unsatisfactory.

Senator **Nunn**. By that you mean that you would like to write off loans of the students have been the victims of a closed school?

Ms. **Doyle**. Yes, we would.

Senator **Nunn**. But the Department won't let you?

Ms. **Doyle**. The Department has said that the policy that guarantors have to use has to be very specific. We have not found it to be a workable policy given the size of the portfolio that would be written off.

Senator **Nunn**. So you don't have a disagreement on the end results, it is a matter of procedure and tactics, is that right, with the Department of Education?

Ms. **Doyle**. Yes, that's correct.

Senator **Nunn**. Mr. Hays, has HEAF been named in any lawsuits in connection with the FITCO/UES matter?

Mr. **Hays**. Mr. Chairman, no we have not. I am sorry, Ms. Doyle tells me that we are named in one by some FITCO investors.

Senator **Nunn**. Where is that pending? Is that in State courts or Federal Court?

Ms. **Doyle**. I believe it is the State court, Sacramento, California.

Senator **Nunn**. Mr. Hays, do schools or lenders that you take action against ever sue you for taking that action? Do you get into cross suits?

Mr. **Hays**. Mr. Chairman, we have. The number of instances I am not sure of. Do you have that number?

Ms. **Doyle**. Yes, UES.

Mr. **Hays**. UES, and what other schools? Any other?

Ms. **Doyle**. The only instance where we have actually been sued by a school where we have taken action—and we have taken many, many actions over the last several years—is National Technical Schools, which is a school owned and operated by UES. We took an emergency action against that school in I believe October of '89. CSAC did the same. We were both sued. We were successful in our suit, which was out here in the District of Columbia, and we reached a settlement whereby the school agreed to withdraw from HEAF's program.

Senator **Nunn**. Mr. Hays, HEAF started guaranteeing FITCO loans in 1985, I am told. Is that about right? I think you said 1986, but somewhere in that time frame.

Mr. **Hays**. Somewhere in that time frame.

Senator **Nunn**. Did you check with any of FITCO's regulators, like the State Banking Department, or conduct a review of FITCO operations before entering into this relationship?

Mr. **Hays**. Mr. Chairman, not to my knowledge we did not.

Senator **Nunn**. You would know if you had, wouldn't you?

Mr. **Hays**. I probably would know. What we have historically done is if a lender is an eligible lender by Department standards, and if that lender is in an area of service of a guarantor, we really have no basis for rejecting a lender agreement for that lender. So we did not check.

Senator **Nunn**. Mr. Hays, what would you do if you were running the Education Department in this overall student loan problem that we have? What are your broad recommendations? You have seen it from a guarantor's side. What is wrong?

Mr. **Hays**. I share Dr. Kipp's view that the major issue is the issue of eligibility and accreditation, and until we have much stronger standards in those two areas, I am not sure we have much hope for dealing with the kinds of problems constructively that we have been talking about here today.

Senator **Nunn**. That's the heart of the problem?

Mr. **Hays**. I believe it is, Mr. Chairman.

Senator **Nunn**. Ms. Jamison, you and Ms. Doyle have both conducted program reviews; is that right?

Ms. **Jamison**. Yes, sir.

Senator **Nunn**. You are out there with the nuts and bolts and doing investigations. Have you run into the Department of Education people doing similar-type reviews?

Ms. **Jamison**. Yes.

Senator **Nunn**. What is the quality of their oversight?

Ms. **Jamison**. In recent years, I have seen an improvement in the quality, and this my own opinion.

Senator **Nunn**. That's all I am asking, your opinion.

Ms. **Jamison**. In the last couple of years there has been a great improvement in Region IX's reports.

Senator **Nunn**. In Region IX's reports?

Ms. **Jamison**. Right. Those are the ones that we would have copies of.

Senator **Nunn**. What was the quality before 2 years ago? Fair, poor, good, what?

Ms. **Jamison**. Limited.

Senator **Nunn**. Does that mean poor?

Ms. **Jamison**. That's hard for me to judge. They were certainly different from the types of reports that our office turns out.

Senator **Nunn**. What was wrong with them?

Ms. **Jamison**. It seemed to me that the scope of the reviews were limited to review of the 799 forms, and very limited in other aspects of the program, as far as due diligence or loan origination. There would be occasional citings, but——

Senator **Nunn**. Have they moved from the "poor" category to the "fair" category now, or have they moved up to the "good" category? Where would you put them?

Ms. **Jamison**. I would say they are probably good, yes.

Senator **Nunn**. Now?

Ms. **Jamison**. Yes. They have a new administrator down there and increased staff and they seem to be doing a much better job.

Senator **Nunn**. Do you think they are understaffed to perform oversight?

Ms. **Jamison**. If you compare their staff with our staff, and we have a staff of 10 reviewers to do the lenders that participant only in the California program, and they have their staff that is about the same number and they are charged with several States, several of the western states.

Senator **Nunn**. So you would say they are really understaffed?

Ms. **Jamison**. Yes. We have difficulty conducting all the reviews that we need to conduct.

Senator NUNN. Ms. Doyle, what has been your experience with oversight at the Department of Education?

Ms. DOYLE. Because we operate nationally, we do see reviews conducted by all of the regions of the Department of Education, and I would have to say that the quality of the reviews ranges greatly from poor to excellent, depending on the region involved and the particular reviewer involved.

Senator NUNN. Is it mainly a matter of competency and training of the people doing the review or, is it a matter of having enough people in some regions and not enough in others? What is the big problem?

Ms. DOYLE. I would say it is a combination. Unfortunately, what I have seen are program review reports issued by the Department which illustrate a lack of understanding of some of the regulations, that don't address all of the issues that we address in our reviews. For example, reviews of lenders that make a statement that since the collection and delinquency servicing of the loans is conducted by a servicer, that the servicing of the loans was not looked at.

Senator NUNN. Mr. Hays, you mentioned a little while ago that you basically could not terminate FITCO because of the default rate alone. If you had cited some legal violation you could have. And therefore you were, I suppose, stuck with doing their business; is that right?

Mr. HAYS. Mr. Chairman, that's right. As I indicated, the Department took the position that short of cause, which then permits a guarantor to undertake what is called under the Department regulations "limitation, suspension or termination," that short of cause which would permit a department to undertake those kinds of proceedings, we had to continue guaranteeing loans for those seven lenders.

Senator NUNN. Well now, when they say you have to keep guaranteeing loans, certainly you have some choice about who you give priority to. I mean, you can't guarantee everybody's loan in the country, right?

Mr. HAYS. Mr. Chairman, one of the interesting things that we found out in the course of that effort was that this is one business where a guarantor may not choose not to do business with another business entity.

Senator NUNN. What if 100 people walk in there at one time with 10,000 loans totaling $6 billion? Somehow you have got to have a priority don't you? You make that judgment call don't you?

Mr. HAYS. Mr. Chairman, if that lender is an eligible institution and we cannot demonstrate violation for cause where we could undertake limitation, suspension and termination proceedings, we have to guarantee those loans.

Senator NUNN. So you are saying that one of your big problems, as you well acknowledge, is the huge number of guaranteed loans related to proprietary schools. There are other guarantee agencies that pretty much stick with 4-year schools or 2-year schools, or have a better balanced portfolio. Are you saying that as a guaranteeing agency you don't have any discretion at all about the balance in your portfolio?

Mr. HAYS. Mr. Chairman, what we were finally able to do, as I indicated, was to withdraw from 18 States. The position the Department took is if a guarantor served any student in a given State or an area of service, then the guarantor must serve all students or all lenders or all schools in that particular area of service. So in July of 1988, we found a way to reduce that proprietary school volume, and our volume between 1988 and 1989 went down from $3.3 billion to $1.8 billion, almost of all of which was in proprietary school paper.

Senator **Nunn**. If you hadn't done that, the situation you are in now would be a lot worse, right?

Mr. **Hays**. And it would have come a lot sooner.

Senator **Nunn**. I want to thank all of you for being here today, and we will keep the record open if you have any other further comments. Dr. Kipp, thank you very much for your testimony. Mr. Fulp, Mr. Hays, Ms. Doyle and Ms. Jamison, thank you. We will have another hearing tomorrow morning on this subject at 9:30 in this room.

[Whereupon, at 1:10 p.m., the Subcommittee adjourned subject to the call of the Chair.]

ABUSE IN FEDERAL STUDENT AID PROGRAMS

WEDNESDAY, SEPTEMBER 26, 1990

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee convened, pursuant to notice, at 9:35 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Sam Nunn, Chairman of the Subcommittee, presiding.

Present: Senators Nunn and Roth.

Staff Present: Eleanore J. Hill, Chief Counsel; John F. Sopko, Deputy Chief Counsel; Mary D. Robertson, Chief Clerk; Alan Edelman, Counsel; David B. Buckley, Chief Investigator; Grace McPhearson, Investigator; Cynthia Comstock, Staff Assistant; Daniel F. Rinzel, Minority Chief Counsel; Carla Martin, Assistant Chief Clerk to Minority; Blaine Phillips, Staff Assistant to Minority; Ellice Halpren-Barnes [Senator Stevens]; Bobby Franklin, [Senator Pryor]; Lois Haas [Senator Wilson]; and Betty Ann Soiefer [Senator Glenn].

OPENING STATEMENT OF SENATOR NUNN

Senator NUNN. The Subcommittee will come to order.

This morning the Permanent Subcommittee on Investigations continues our examination of the financial players in the student loan program. Specifically, we continue our examination this morning on the largest single failure this program has experienced. Yesterday we received testimony describing how the First Independent Trust Company, a one-time leading originator of student loans, repeatedly failed to properly report its loan volume to the U.S. Department of Education, and repeatedly failed to forward origination fees to the Department of Education, fees that instead were used allegedly in some cases for corporate expenses.

We also heard that despite repeated findings of these and other alleged improprieties by regulators, FITCO was allowed to continue to participate in the student loan program. Moreover, we heard that United Education and Software, UES, a corporation which owned dozens of proprietary schools and which was also responsible for servicing over $1 billion of FITCO-originated loans, through mismanagement and possible fraud, failed miserably in its efforts to service these loans. The violations by both parties, intentional or not, led to eventual financial collapse of FITCO and possibly of huge losses for some of the world's largest banks, the Bank of America, the Higher Education Assistance Foundation, the California Student Aid Commission and ultimately the American taxpayer.

This morning we will continue to examine the details of the FITCO story from those who are perhaps most familiar with it, the company's investors, its regulators, and finally the presidents of both FITCO and UES. We look forward to their testimony, not only for an explanation of why this happened but also for some insight on how to prevent it from happening again.

Our first witness this morning represents hundreds of individual investors. He himself is an investor in the First Independent Trust Company. Mr. Voelm will tell the Subcommittee about the promises FITCO made to investors, about the security of their deposits, and the guaranteed rate of return these investors were to receive on their investments. He will also testify about the impact of FITCO's failure and how that has affected the investors.

We welcome you this morning, Mr. Voelm. I will ask you to take the oath before you take your seat.

Do you swear the testimony you give will be the truth, the whole truth, and nothing but the truth so help you God?

Mr. **Voelm.** I do.

Senator **Nunn.** Thank you. We appreciate you being here.

TESTIMONY OF GREGORY VOELM, REPRESENTING INVESTOR VICTIMS, STUDENT LOAN TRUST TASK FORCE, FIRST INDEPENDENT TRUST CO.

Mr. **Voelm.** Senator Nunn and guests of the Subcommittee, I am Greg Voelm and I am here to tell you that this problem is not just about big financial institutions and Government agencies. It is about children and retired people and parents and working men and women who relied on the full faith and credit of the United States to protect the funds they placed in trust to help students get an education.

Let me start by telling you about Jonathan. He is 7 years old. He is my son. He put his meager little savings into FITCO because I told him it was the right thing to do. I told him he could trust the Government. Now I don't know what to tell Jonathan. We live in California, but Jonathan has a picture in his room of the Washington skyline. In that picture, the Capitol dome glows fn the moonlight like a temple of justice. Jonathan asks me when the Government is going to return the savings we put up to help students go to school. He knows that I have been working for 17 months to get back our money and the savings of thousands of other families. I keep telling him I am sure we will have our money back soon son, but it is hard to hold back the fear and the bitter feeling of being betrayed.

The people who sent me here to talk for them are solid citizens, but they are hardly your idea of high rollers. They include small businessmen, the Shiloh Baptist Church, doctors and carpenters, judges and secretaries, lawyers and truck drivers. And there are hundreds of retired people whose life savings are now being held hostage by the actions of the United States Department of Education.

Many of us who have been devastated by the Federal loan disaster are from the West Coast, but our people also represent most of the other States in the country and the District of Columbia. We are not fools. We simply trusted the full faith and credit of the United States as it was given to us. We put our money in trust with an approved lender in the student loan program, First Independent Trust Company. We call ourselves trustors. We really are not investors, because we were not gambling on the fortunes of FITCO. Our return was limits to T-bill plus a percent and a quarter. In the last full year of the program, this averaged only 8 percent.

We are not stockholders. We could never profit from the operations of FITCO. In fact, we are forbidden by law from managing our own accounts.

What we are is people who accepted a modest, predictable return guaranteed against default by the United States Government. When we chose this modest return, what we also got for our money was the feeling we were helping students. And here I should add all of us, everybody that I have talked to, believed that it was college students we were helping. I have not met one of our thousands of members who ever knew that FITCO was engaged in making loans to risky trade schools.

FITCO assigned our accounts to individual students. There are students walking around out there with Greg Voelm loans. Even at 8 percent it seemed like such a good, safe investment that I put half of all the money I have in the world into student loans. My son Jonathan put $68, all of the money he has.

Many people put up their entire life savings. The student loan program attracted $30 million from trustors. In return for our money, we got a guarantee in writing. One of the documents that shows that guarantee is right up there, and I will read the guarantee to you. The program bears, "The full faith and credit of the United States Government, the highest priority guarantee for a financial instrument, safer than FDIC or FSLIC, which are secondary to the full faith and credit of the Government."

We also got some legal documents which I have included as exhibits, and I will just pick up a couple of what I think are important lines from those documents. The principal will be, "Invested and reinvested by the trustee in obligations fully insured or guaranteed by the United States Government for which the full faith and credit of the United States is pledged."

And I think this one is important. "The undersigned trustor understands that to retain their full guaranteed status, reinsured status, or full faith and credit status, these obligations may be held only in the name of First Independent Trust Company, an eligible lender who has been approved by the United States to hold the same."

Over the entrance to the main headquarters of FITCO are these words: "Education is the safest investment." They were about a foot high, and there is a photograph of that entrance in your exhibits.

These words, "Education is the safest investment," are a quote from the president of First Independent Trust, Deno Evangelista.

Why should we believe First Independent? Well, as we have seen, FITCO was an approved lender, in fact, one of the largest lenders in the country. FITCO was regularly audited by the Department of Education, and if that were not enough, the financial institution was chartered and audited by the State of California. Sadly, as you have seen, the Government knew about abuses at FITCO and failed for years to take action, and they never even warned us trustors.

Is it fair to say that the guarantee of full faith and credit came from FITCO, or was it really from the Government? Well, it was made in the name of the Government in a program in which such guarantee certainly was available by an organization approved and audited by the Government. According to Jack Keefe, who will be testifying after me, he and other auditors from the Department of Education had access to FITCO material. In fact, the Washington office of DOE even stopped FITCO from commission marketing student loans on campus. Unfortunately, they never did stop FITCO's representation of full faith and credit.

I asked the Department of Education administrator responsible for the student loan program why they didn't stop FITCO when they had proof that FITCO was breaking the rules. "Who can keep track," he said, "we have so many programs." This lack of courage and basic human responsibility has caused people to cry and suffer and fear for their children. I will tell you four stories. A young mother wrote Secretary Cavazos shortly after the FITCO collapse. Her letter said, in part;

> I am pregnant with our first child. I work on a commission basis and do not have health insurance through my company. Our health insurance was our savings in First Independent Trust. We have been saving this money to cover medical expenses and other costs we will have as a result of the addition to our family. We worked hard and sacrificed to save and put up all our savings into FITCO. Now we have been forced into the financial situation we worked so hard to avoid. We have no cash to cover medical expenses or emergencies.

Pete Ransani was a pretty good boxer. Some of you may remember him. He was a contender for the WBA welterweight crown a few years back. Now Pete works in Corrections. All his savings were in student loans. If you have ever boxed or watched a boxing match close-up, you know that you get hurt even if you are good. Imagine pushing yourself out to fight again and again and again, even though your mouth is cut and your eye is half swollen shut. Now think about having everything you bled for taken away by somebody who doesn't even have the courage to face you.

For years Margaret's husband withheld part of his pay to protect them when they were older. Three years ago he died and left Margaret alone. She has been trying to get a job, but that is hard to do when you are 75.

None of us trustors have been able to get our savings since May of 1989. To make the damage even worse, to rub salt into our wounds, the Department of Education is still insisting that the trustors come up with $4.4 million to cover origination fees that the Department failed to collect from FITCO.

Senator NUNN. Mr. Voelm, did you or other trustors sign something that makes you individually liable, that you are aware of?

Mr. VOELM. No, I am not aware of anything, Senator.

Senator NUNN. I was just wondering what is the basis of the Department of Education's claim.

Mr. VOELM. I think their basis is that we are the last people standing at FITCO. They can't squeeze any blood out of the corporation so they will take it from us.

Senator NUNN. We will be asking them about that, but I am not aware of any personal guarantee. You are not aware of any personal guarantee or notes. Did you sign notes, or was your investment in cash?

Mr. VOELM. No, we were strictly trustors, we were not investors. All we could get back was our own money.

Senator NUNN. But you put money in it, right?

Mr. VOELM. Yes, but it was specifically for student loans. It was not an investment in FITCO.

Senator NUNN. You didn't sign anything, you basically put cash in the——

Mr. VOELM. Right. And what we signed is what I quoted to you, that we were investing in student loans and they bore the full faith and credit. And you will have to ask the Department. I certainly don't understand their logic.

Senator NUNN. Are they actually suing you or just making that claim?

Mr. VOELM. They have made a claim and the State Banking Department of California, which is liquidating FITCO, has signed an agreement with them to give them that money and they are trying to raise it now. As far as I am concerned, this is the most egregious example of punishing the victims that I have ever heard of.

It has been a year and a half now and three of our older trustors have already died without their money. Carole Percival is still hanging on. She had cancer surgery 3 years ago. Although the $50,000 represents her retirement savings, she says she isn't as concerned for herself as she is for her children, ages 8 and 12. She doesn't see how they are going to get to college without her help.

For us this tragedy can end now. Secretary Cavazos was the authority to declare our portfolio whole without the payment of extortionary charges. Richard Hawk, Chairman of the Board of HEAF, has assured me that he is prepared to honor all our guarantees at the direction of Secretary Cavazos.

Senator Nunn, when Secretary Cavazos testifies before you in 2 weeks, please ask him why he thinks it is the right thing to do to keep our money.

I represent the only individuals in the history of the United States who put up their own money to make student loans. We have no responsibility for the Department's troubles with FITCO, Bank of America, UES, or HEAF. We do not deserve to suffer for believing in the goals of the student loan program. I hope you can help us. More than even getting my money back, I want to be able to tell my son Jonathan that his Government is fair.

Senator NUNN. Thank you, Mr. Voelm, we appreciate you bringing the story of another set of victims to our attention in a vivid way.

When you say that the Secretary of Education could make you whole by giving back the money that they have of yours, you really are not talking about the Department of Education having that money, are you?

Mr. VOELM. No, only in the sense that what FITCO made were student loans and however badly those were administered, they were real loans under the real student loan program, and the Secretary has the discretion to honor those loans. We are not asking for a bailout, we just want our money back.

Senator NUNN. But for the Secretary of Education, that money is in effect gone.

Mr. VOELM. Well, again, it was real loans and he has already signed a document that for $4.4 million agrees to honor the loans. So what I am saying is why should we pay $4.4 million for the Department's lack of ability to run their own program in the past.

Senator NUNN. You are talking about the additional claim, he is trying to collect more money you mean?

Mr. VOELM. He is trying to collect fees that the Department didn't collect over the last 8 years.

Senator NUNN. I guess what I am trying to ask is are you saying that the Department should reimburse you what you have lost, or are you saying that they should make no further claim against you?

Mr. VOELM. I am saying they should just make sure that we get our money back, and they can do that by not demanding that we pay $4.4 million for their past troubles. So we are not asking for any kind of a bailout, we just would like our savings back. We just want to be held whole.

Senator NUNN. But you want your money back. How much have you invested as a trustor?

Mr. VOELM. Personally?

Senator NUNN. Yes.

Mr. VOELM. Over $100,000.

Senator NUNN. And you are saying you want that money back?

Mr. VOELM. Yes. I haven't been able to get it since May of last year. And I can survive, but there are a lot of older people who have had really tough times.

Senator NUNN. Well, I understand that. What I am puzzled about though, and maybe I am confused on this point, you are saying you think they should not claim against you to collect further money?

Mr. VOELM. Yes. There are real loans which may have had processing difficulties. Again, that had nothing to do with us, that was all somewhere in the system, we didn't have anything to do with. But those loans can be sold if they are honored by the Department, and the Department has agreed to honor them, but what they want, what I feel is extortion, is for our accounts to be responsible for paying the Department for the fees in the past that they didn't collect.

Senator NUNN. In order to honor those loans?

Mr. VOELM. Yes. And all we are saying is honor the loans, but you don't have a right to take from us money for your past mistakes.

Senator NUNN. Did you feel that you had no risk when you invested this money?

Mr. Voelm. Absolutely none. I am a businessman and I have lots of places to get a better return than 8 percent if I am willing to accept risk.

Senator Nunn. But wasn't the return higher than 8 percent when it was advertised? Wasn't FITCO paying more than anybody else really when you invested?

Mr. Voelm. Well, it varied with the T-bill. It has never equaled the return I get from other investments, but had interest rates were high it certainly was higher than 8 percent. But mostly what it was was a safe investment that I felt proud about. I liked telling people that I was helping students go to school, and yes it was liquid, and yes it fluctuated automatically with T-bills so I didn't have to watch it all the time.

But when I went to First Independent in 1981 and first put my money down, I actually took Deno Evangelista aside and asked him—I said, I see in writing that this is fully guaranteed, what happens if you go bankrupt? And he told me of course, we will never go bankrupt, but all that would happen is that another bank would come in and take over the loans, because they are absolutely guaranteed loans; as it says right there, it is safer than any other institution.

Senator Nunn. And I understand why people would believe that. But, that wasn't the Government saying that was it, that was actually First Independent saying that? You never made a deal with the Government, did you?

Mr. Voelm. Well, we thought we were.

Senator Nunn. That is what you thought?

Mr. Voelm. Yes. And to extend the logic for a minute, suppose that I went to the Federal Reserve Bank in San Francisco to buy a T-bill, and just for the sake of argument suppose that somebody had knocked the clerk in the window over the head and had put on a Federal uniform but they weren't really a Federal person and I bought a T-bill there. I mean, I suppose you could say I was a fool for believing they were a Government agent. But we thought, based on the fact that FITCO was certainly an audited and approved agency dispensing student loans, we felt we had a Federal guarantee. And in no way were we investors, in no way could we make a penny from any operations that FITCO did. We simply thought we were holding something equivalent to a savings bond.

Senator Nunn. Did you think that FITCO was a federally guaranteed agency? Did you think they had FDIC insurance? Was there any hint of that?

Mr. Voelm. No, I could tell the difference, but as the letter said, what they had was safer than FDIC. So we relied on full faith and credit.

Senator Nunn. Did they have any kind of State insurance program, or was it simply the loans themselves that you felt had the full faith and credit?

Mr. Voelm. Well, it was the loans themselves, but as a consumer—I mean, I am probably more sophisticated than most people—and I didn't feel that I had to delve much deeper than to find out that they were an approved lender under the student loan program and that student loans bore the full faith and credit and that they were chartered by the State of California. I thought that was enough.

Senator NUNN. Well, there is no doubt about the fact that they advertised it that way.

Mr. VOELM. They advertised it on the radio, in the phone book, in the newspaper.

Senator NUNN. So on behalf of the trustors that you are representing, you are basically saying that the Department of Education should honor the guarantee on those loans and not require any kind of offset for commissions or other matters that were not properly handled by FITCO?

Mr. VOELM. They should make sure we get our money back. It is the only right thing to do.

Senator NUNN. Well, does this mean that in any financial institution handling Federal loans that people have invested in, if that principle applied, that there would be zero risk to anyone ever holding deposits or investments in those institutions?

Mr. VOELM. I can't speak for the whole Federal Government.

Senator NUNN. I know, but that is what basically the precedent would be. You are asking the Government to hold harmless the investors in an institution having no Goverment insurance that basically went broke.

Mr. VOELM. Well, I think that this is a specific case of an institution that claimed the full faith and credit of the United States with the full knowledge of an agency of the United States. I hope this will never happen again.

Senator NUNN. You are saying because they made that claim and the Department of Education didn't do anything about it to correct it?

Mr. VOELM. I am not a lawyer, but they call that estoppel or something. But yes, it is obvious that the Department of Education was in there and knew, or should have known, that the claim was being made and they knew and they did nothing.

Senator NUNN. Did FITCO tell you, or did anyone representing them, that they were making loans to 4-year colleges or to community colleges, or did they tell you that they were making loans to proprietary trade-type of schools?, What did they tell you about what type loans they were making?

Mr. VOELM. No, Senator, at least to me they never said either way. It was just my assumption that they were college loans. I didn't even know that trade schools were a major player in the program. In fact, they weren't. When I put my money into FITCO originally they weren't much in the program at all.

Senator NUNN. What year was that that you first invested?

Mr. VOELM. 1981.

Senator NUNN. When was the first time you felt that there was a real problem here? When were you alerted to a problem?

Mr. VOELM. I had heard rumors of trouble in 1986, 1987. The State apparently, as they audited, FITCO often found serious trouble. And so, I heard the rumors that there was trouble at FITCO, but I was assured by FITCO staff that everything was completely safe and there was no worry anyway because they were federally insured loans, so I stayed there.

Senator **Nunn**. Did FITCO tell you that they were investing any of this money in anything other than loans?

Mr. **Voelm**. No. And again, we didn't—the feeling we had was that we were not investors in FITCO or that FITCO was not playing with our money in any way. We didn't know they were churning the loans twice a month either. Our image was there are students walking around there with loans that we have made possible, and that is as solid as the Government is solid.

Senator **Nunn**. All right. So you didn't know they were churning loans or that they were investing primarily in proprietary schools?

Mr. **Voelm**. No. I guess there is a regulation that would prohibit us from in any way managing student loans, at least that is what the trust documents we signed said, that they had to be held in the name of First Independent, which was a lender approved to do that by the United States Government. So we felt that they were acting on behalf of the Government in the same way that when you deposit your Federal withholding insurance at your bank that they are acting as a depository for the Government.

Senator **Nunn**. When you first invested, was FITCO paying the highest yield around town in terms of financial investments?

Mr. **Voelm**. I really don't know. Again, I knew the yield was better than—slightly better than money market yields, but I didn't shop all over town.

Senator **Nunn**. I have got a letter here dated February 17, 1984, and it is from FITCO that basically sets forth their rates compared to every other rate. Did you ever see that letter?

Mr. **Voelm**. It is right here. It is the same letter that guaranteed the full faith and credit.

Senator **Nunn**. This is the same letter you have. Okay. Their rate is 10.76 with an annual yield of 11.20, and the nearest one to that is Sacramento Valley Bank, which is 9.25, and they go right on down the line. Capital Federal, 8.75, Bank of America, 8.40, Crocker, 8.40, Great Western 8.55, Sacramento Savings, 8.65, and Wells Fargo 8.40.

Did you believe that this kind of yield was also 100 percent guaranteed? I am just curious how you would feel you could get an extra couple of points and have zero risk.

Mr. **Voelm**. Actually, what I thought was that that return was the result of them being able to participate in the Federal program. I knew that the actual return to student loan lenders—people who hold student loans—is several points above that, so it only seemed reasonable that they, after they take out their own administrative expenses and profits, should be able to pass along a rate of return that is 2 or 2.5 points below what they are making on student loans. To compare that to what an investor would get if they were to buy a second mortgage, which is an investment that bears very little risk but some risks, it is 3 points less than they get for a second mortgage.

Senator **Nunn**. But on a second mortgage the Government has nothing to do with it.

Mr. **Voelm**. Exactly. My point. So yes, it was a good return, but none of us felt that it was an outrageous return. And since it was 8 percent in the last year that they were in operation, it was nothing we would get really excited about, it just seemed safe.

Senator NUNN. Okay. Well, we will be asking the Secretary the questions you posed here this morning I assure you.

Mr. VOELM. Good. I appreciate it.

Senator NUNN. Thank you very much, Mr. Voelm. We appreciate your being here. Good luck to you.

Mr. VOELM. Thank you.

Senator NUNN. Our next witnesses will testify as a panel. Mr. Jack Keefe is a retired Department of Education employee from California. Mr. Keefe and his program review staff oversaw hundreds of lenders in 14 States, including FITCO and the California Student Loan Finance Corporation. Since his retirement, Mr. Keefe has assisted the California Banking Department in the liquidation of FITCO. Mr. James Gilleran is Superintendent of Banks for the State of California. Mr. Gilleran, although relatively new in his position, heads the State agency which granted FITCO their charter as a trust company in 1975 and oversaw FITCO's operations. Mr. Gilleran's agency made repeated adverse findings during their reviews of FITCO for several years prior to seizing the trust for liquidation in 1989.

Gentlemen, we appreciate both of you being here this morning. Mr. Gilleran, we will have you lead off this morning. Let me give both of you the oath; we swear in all witnesses before the Subcommittee.

Do you swear the testimony you give will be the truth, the whole truth, and nothing but the truth so help you God?

Mr. GILLERAN. I do.

Mr. KEEFE. I do.

TESTIMONY OF JAMES E. GILLERAN, SUPERINTENDENT OF BANKS, STATE OF CALIFORNIA

Mr. GILLERAN. Mr. Chairman, my name is James E. Gilleran and I am Superintendent of Banks in the State of California. In accordance with your request, I have submitted a written statement and I respectfully ask that it be entered in the record.[1] At this time I would like to just briefly summarize that statement.

You have asked me to present a history of FITCO from the perspective of the regulator. FITCO was closed in May of 1989, almost 2 months before I took office as Superintendent of Banks. Consequently, I do not have personal knowledge of FITCO's operations. However, I have gained some knowledge of FITCO in overseeing its liquidation, and I have made a limited review of FITCO's history. At this time, therefore, I believe I have sufficient information to respond to your request.

FITCO was a California State chartered trust company. As such, it was licensed by the State Banking Department under the California banking law, and it was subject to many of the same provisions of that law as commercial banks. However, trust companies are different from commercial banks. Commercial banks are authorized to accept deposits in the general sense of the term. Subject to very limited exceptions, trust companies may not accept deposits and are not insured by the Federal Deposit Insurance Corporation.

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[1] See p. 390.

During its first 5 years of business, from 1975 to 1980, FITCO engaged in what might be called a conventional trust business. In 1980, FITCO entered the student loan business.

When we talk about trust companies, we must bear in mind that a trust company may act in either of two capacities, namely in a fiduciary capacity, which means as trustee or other fiduciary, or in a corporate capacity, which means in its own right and for its own account. In the jargon of the trade, a trust company has two sides, therefore, the fiduciary side and the corporate side.

On the fiduciary side, FITCO solicited and accepted funds for what it called trust rate accounts. The funds were held by FITCO as trustee with the customer as trustor and beneficiary. FITCO used the funds in the trust rate accounts to make student loans. FITCO usually sold the loans shortly after making them. FITCO also made student loans on its corporate side through UES.

Significant problems in FITCO's student loan operations were first identified in the examination that the Banking Department commenced in August of 1985. Additional problems showed up in subsequent examinations.

Some of the examples of the problems were that FITCO advertised the trust rate accounts as if they were commercial bank deposits and FITCO called itself a bank. Second, FITCO departed from usual trust procedures in administering the trust rate accounts. Its operations were deficient. For instance, it failed to reconcile its bank accounts and internal accounts on a regular basis. And fourth, the Banking Department questioned whether FITCO qualified as an eligible lender under the Higher Education Act of 1965. Back in 1986, the Act required that FITCO be a State chartered bank and that the making of student loans not be its primary consumer credit function.

In an effort to correct the problems at FITCO, the Banking Department conducted examinations on approximately an annual basis, and made visitations between some of the examinations. In addition, the Banking Department required special reports from FITCO, and it was in frequent contact with it.

Also, the Banking Department met several times with FITCO and its attorneys and corresponded at length with them. FITCO was uncooperative and even recalcitrant. Nonetheless, the Banking Department did achieve corrections in some areas, though not in at all.

On advertising, FITCO insisted almost to the end that it was entitled to call itself a bank. Indeed, FITCO even filed a lawsuit on the matter against the Banking Department. However, FITCO stopped the other objectionable advertisements, and it distributed to its customers a brochure giving clarifying information on key questions about the trust rate program.

On administration of the trust rate accounts, some improvements were accomplished. Also in operations some progress was made. However, FITCO failed to maintain the progress and eventually lapsed back into its deficient ways.

On the question of eligibility, the Education Department and the California Student Aid Commission ruled that FITCO was an eligible lender. Eventually the Federal statute was amended to confirm

FITCO's eligibility and eliminate the issue that the Banking Department had raised.

In April 1989 the Banking Department commenced what was to be its last examination of FITCO. The examination showed that tangible capital, after the Banking Department's adjustments, was in a deficit position. When FITCO failed to replenish its capital, the Banking Department took possession and placed FITCO in liquidation on May 19, 1989.

The problems that we have encountered in liquidating FITCO are largely student loan problems. Therefore, a brief report on the liquidation may be helpful to the Subcommittee. FITCO failed to pay origination fees on the loans it made. The Education Department filed a claim for $4.4 million of origination fees. It also filed a claim for an additional $1.2 million on the basis of an audit which concluded that FITCO's delays in processing cancellations of student loans had caused the Education Department to pay excess IB&SAP. Asserting that FITCO had originated student loans as trustee of the trust rate accounts, the Education Department pressed its claims against both FITCO and the trust rate accounts.

We disputed the liability of the trust rate accounts. However, if the origination fees were not paid, student loans originated by FITCO might have been treated as uninsured. To contain that risk, we agreed to settle ED's claim for $4.4 million. We have proposed that the trust rate accounts in each of the five secondary market institutions that hold loans originated by FITCO on which origination fees are unpaid, pay their proportional shares of the $4.4 million. The portion relating to the loans of the trust rate account holders would amount to about $400,000 of that $4.4 million. The secondary market would be paying the rest of it.

Senator NUNN. Could you tell us then, we just had Mr. Voelm testify, and let's say he is a trustor and he has got $100,000 in FITCO. Would you walk us through how this suggested settlement would affect that $100,000?

Mr. GILLERAN. Well, if we put it in total, what we are in the process of doing——

Senator NUNN. When you say "we," you are talking about the State Banking Department?

Mr. GILLERAN. Banking Department.

Senator NUNN. And you are working with the Department of Education?

Mr. GILLERAN. No, we are the liquidators of the former trustee, FITCO, and as the liquidators, what we are trying to do is to settle up all of the accounts of FITCO.

Senator NUNN. But the Department of Education comes in here, don't they?

Mr. GILLERAN. The Department of Education comes in here because the major assets of the trust rate account holders are the student loans. Those student loans are valueless unless the Education Department holds on its guarantee. It will not hold on its guarantee unless it is paid its origination fees that are unpaid to it of $4.4 million.

Senator NUNN. Right. I understand.

Mr. GILLERAN. We disagree with the Department; we don't think the trust rate account holders should have to pay that. However, in order to settle with the Education Department, since without their guarantee it is worthless in total, we have agreed to settle with them. Of the $4.4 million, the amount that would come out of the trust rate accounts' money would be about $400,000.

Senator NUNN. Where would the rest of it come from?

Mr. GILLERAN. That would come from the secondary market to whom FITCO has sold the loans.

Senator NUNN. So $400,000 would come out of how much money that the trustors——

Mr. GILLERAN. The trustors, the trust rate accounts, have put in approximately $30 million, and the $400,000 would come out of that. However, let me finish up on this because there are other amounts that would be coming out of that.

Senator NUNN. Okay.

Mr. GILLERAN. Also FITCO failed to process cancellations and refunds on student loans. We reconciled FITCO's bank accounts and identified the cancellations and refunds. On the fiduciary side, the cancellations and refunds totaled $5.7 million, and there are sufficient funds to pay them in full. On the corporate side however, the cancellations and refunds totaled $3 million, but there are only $800,000 in cancellation and refund monies, resulting in a shortage of $2.2 million. We have prepared and sent lists of the cancellations and refunds to the holders of the student loans. Also, subject to court approval, we have proposed to pay out the cancellation and refund monies on the fiduciary side in full, and the cancellation and refund monies on the corporate side on a prorata basis.

I just want to add that everything that we do as a liquidator is subject to the approval of the Superior Court in Sacramento.

Senator NUNN. So could you tell us how much of that money would come out of that $30 million that the trustors put up?

Mr. GILLERAN. Nothing, because of the fact that any of the cancellations and refunds that came in on the fiduciary side, there were sufficient funds in the fiduciary accounts to pay them. What has to happen is that in order to achieve this settlement, the other secondary market players that bought loans from FITCO have to agree that we only return $800,000 to them in corporate cancellations and refunds, because simply that is all that is left.

There are disputes with virtually all of the secondary market institutions to which FITCO sold student loans. Like the Education Department, the secondary market institutions have asserted their claims both against FITCO as well as against the trust rate accounts. On this point, Mr. Chairman, you raised the question of under what bases are they raising this question that the trust rate accounts are liable. And the basic premise is that--or the point at law under which it is raised—is the fact that the trustors are responsible for the acts of the trustee. That is generally the broad rule of law here that is in question.

While we have contended that the trust rate accounts are not liable, we are attempting to resolve the disputes through settlements. HEAF guaranteed a large part of the student loans originated by FITCO. HEAF's financial difficulties have been widely publicized. If HEAF is unable to pay on its guarantees, the trust rate accounts will suffer large losses. In addition, we have encountered serious problems with HEAF. HEAF is imposing requirements above and beyond what the Education Department has required, and the extra requirements are threatening additional losses for the trust rate accounts.

As you can appreciate, before the Education Department guarantee even applies, HEAF would have to agree to pay. And if HEAF is asserting problems that even the Education Department isn't asserting, then this again threatens whether or not the trust rate account holders will get their money back.

After adjusting for the actual and estimated losses determined to date in the student loans held for the trust rate accounts, and after also adjusting for the losses involved in the settlements with secondary market institutions, we calculate that the trust rate accounts have thus far suffered losses of $5.1 million. This is against total assets of $33 million. The reason why it is 33 instead of 30 is the fact that that would include the interest that the $30 million would have achieved to date by investing in the trust rate accounts.

Additional losses are anticipated but we cannot estimate the amounts at this time. Those additional losses would be if HEAF were not to pay loans because they were asserting claims, and when we get through the final liquidation, in order to get any money at all to the trust rate account holders, we have got to sell the portfolio to somebody who is willing to buy it as an investment, and in that process there might be additional discounts because a borrower would want to get a yield high enough to compensate for whatever risks there are in the portfolio he is buying.

We have filed a civil action against FITCO's directors and executive officers in the California Superior Court, alleging that they were negligent and breached their fiduciary duties. In addition, we have referred the FITCO matter to the local district attorney, and his office is conducting a criminal investigation.

I would like to bring one matter to the Subcommittee's attention, and that is communication between the regulators of financial institutions and the Government agencies that administer programs in which these financial institutions participate. We have had good communication with the Federal bank regulatory agencies. However, the lines of communication with Government agencies that administer programs in which our licensees participate has not been good. In the FITCO case, while we had some contact with the Education Department and the California Student Aid Commission, I believe the communication between us and ED and CSAC could have been better. For example, we did not have immediate and direct information on the program reviews that CSAC made of FITCO, except for the last review. Also, we were not informed that the Education Department objected to FITCO's deferring payment of origination fees. Communication between the regulators of financial institutions and the Government agencies that administer these programs in which those financial institutions participate may in some measure be impeded by statutes that restrict Government agencies in providing confidential information to other agencies. Changes in such statutes may be in order, and I would respectfully suggest that the Subcommittee consider this matter.

Thank you, and whatever additional questions you have, I would be happy to answer.

Senator **Nunn**. What changes would you recommend from your perspective?

Mr. **Gilleran**. Well, I think that any of the prohibitions regarding the exchanging of information between agencies as its relates to confidential information be eliminated, or that it be taken away as a problem in the communication process. As it is now, there are certain statutes that prohibit communication of, for instance, personal trust information to outside agencies.

Senator **Nunn**. Mr. Gilleran, the State Banking Department reviews of FITCO, as we have determined based on working with your department, disclose what appear to be repeated violations of law by FITCO. Do you agree with that in general? The ones that have come to our attention—let's take them one by one—are continuing capital impairment, was that the case?

Mr. **Gilleran**. There were discussions between the State Banking Department and FITCO on capital, additional capital requirements, starting in early 1987. I believe when FITCO originally started it had capital of something like, say, $500,000. The State Banking Department wanted to have that brought up to, say, a million dollars, and discussions were being held in early 1987 regarding that matter. But then 1987 was the best year that FITCO ever had and it ended that year with capital around $2 million. So I can't say that it had repeated violations of law because of capital requirements, no.

Senator **Nunn**. Okay. How about misleading advertising?

Mr. **Gilleran**. On the subject of advertising, the Department, as I have said, objected to what FITCO was doing, told FITCO to stop, and after what I understand was protracted conversation on the subject, FITCO did stop advertising in the way they were doing it, and it is my information that they also sent out a brochure to the trust rate account holders which further described in greater detail the exact nature of the trust rate account.

Senator **Nunn**. Do you have a copy of that? Could you furnish a copy?

Mr. **Gilleran**. Yes, I have a copy of that with me.

Senator **Nunn**. When was that sent out?

Mr. **Gilleran**. I don't know the exact date when that was sent out. But again, that was an area where the Department objected to what they were doing and FITCO changed and then sent out this brochure. So I can't characterize that as a violation of law either.

Senator **Nunn**. You heard Mr. Voelm testify about the impression he had as a person that put money in this. And he felt—and he said a lot of other people felt similarly—that basically the U.S. Government was backing this up, that it was really a no-risk investment. Do you think that that was a reasonable deduction that people who put money in FITCO could have concluded based on the advertising and based on the information FITCO was putting out?

Mr. **Gilleran**. Well, I don't know what was in their heads, because it is quite possible that somebody did believe that. The fact of the matter is that there is no such thing as a no-risk investment, and I think you pointed out the differences between the interest rates that banks were paying.

Senator **Nunn**. But I am saying based on what they were putting out about FITCO and the student loan investments being safer than FDIC or safer than any other guarantee as in the full faith and credit of the United States behind it. I mean they said all of that. Do you think that is misleading?

Mr. GILLERAN. Well, I would say when you simplify it to that extent and say nothing further, that it may be. However, if you read this disclosure document that was sent out, I think it is clear that this is not a straight guarantee as the FDIC insurance is where if the bank doesn't pay the FDIC pays. There are so many operating steps and intervening guarantee agencies that it just isn't that simple.

Senator NUNN. To try to make it that simple is misleading isn't it?

Mr. GILLERAN. To make it that simple would, I believe, be misleading, but they did send out correcting information I am told.

Senator NUNN. I don't know whether they corrected it or not. This paper we have got here, this is a 10 page—at least 10 page—document that is full of all sorts of small print, just looking over it, and what they sent out to begin with was one page with those bold assertions. It seems to me that somebody would have to be a lawyer or a tax accountant and go through here in great detail in order to say that this corrects that. Maybe it does. I haven't read it, but I would say that nevertheless if they continued to put out that other information or did not correct it in the same kind of form that they put that out in, this would not correct the problem I wouldn't think.

Mr. GILLERAN. I am not trying to justify what FITCO did or say that it did correct it in the minds of the trust rate account holders. I am just trying to say what was done.

Senator NUNN. Do you think FITCO had a lack of proper fiscal controls?

Mr. GILLERAN. Well, I can tell you that the Department was critical of their operating procedures, starting probably as early as 1983, and was working with FITCO trying to get them to change. And in several of the cases they would change, in other cases they would promise to change and then backslide. So in certain cases, you know, their operating controls were deficient. And in reviewing all of the criticisms that the Department made over time, they had never gotten to the extent where the Department had concluded that FITCO had to be closed because of these deficiencies.

Senator NUNN. Didn't they have a lack of capital or capital impairment way back in the 1970s, 1975, 1976, 1977?

Mr. GILLERAN. I am not aware of it. It was formed in the mid-1970s.

Senator NUNN. We have got copies of your report, December 9, 1977. This says, "Third examination discloses that after 2 full years of operation the company has been unable to meet projected growth and continues to experience operating losses which total $180 million to date. No break-even point can be anticipated at this time in view of lack of demonstrated ability of directors to plan, organize, and control growth and profitability of the company."

Here is a report from 1975 showing a deficit operating condition. Here is one in 1976 showing a deficit operating condition. I guess my question is, was any of this information made available to the Department of Education or to HEAF or any other agency? You mentioned the communication could have been better. Is there any procedure whereby the California Banking Department makes this kind of information about one of the financial institutions available to other interested agencies, Federal and State?

Mr. GILLERAN. We share information of this kind with the bank regulatory agencies.

Senator NUNN. FDIC and so forth?

Mr. GILLERAN. FDIC, Comptroller of the Currency, et cetera, but it is not made available on a routine basis to other agencies, and that goes back to my recommendation that that be looked at.

Senator NUNN. You are saying that law precludes that, is that right?

Mr. GILLERAN. In general, the law precludes these bank supervisory agencies sharing their information. It is considered to be confidential, except with other bank regulators.

Senator NUNN. And you think there should be some exceptions to that in this area?

Mr. GILLERAN. I think so.

Senator NUNN. Are you familiar with the records as to why the State Banking Department didn't want to grant a charter to FITCO at the beginning? Have you looked into that?

Mr. GILLERAN. My understanding is that when the original request for a charter was made, the State Banking Department was not satisfied with the original plan that was put together, and then those that were proposing the charter for the trust company went to court and sued the Department to get the court to order the Department to grant the license. In the meantime, the proposers amended their plan and corrected the plan to the extent that the State Banking Department was then satisfied that on that basis that a charter could be granted and a charter was granted.

Senator NUNN. In 1985 and 1986, didn't your Banking Department question FITCO's eligibility to participate in the student loan program?

Mr. GILLERAN. It did.

Senator NUNN. And what caused you to have those questions?

Mr. GILLERAN. I think that we were on the basis—on two bases. One was that at that time the Department thought that the rules required FITCO to be a commercial bank and it was not. And secondly, that a question was on the basis of whether or not FITCO could have 100 percent of its lending in the student loan area.

Senator NUNN. Did you notify anybody at the Federal level about those concerns?

Mr. GILLERAN. Yes. It is my understanding that the Department had conversations with CSAC, and I believe the Education Department, on those issues, and that finally, as you know, the statute was changed to grandfather FITCO.

Senator NUNN. Were you surprised when that statute was changed, or were you there? Was your department surprised? You weren't there then.

Mr. GILLERAN. I wasn't there.

Senator NUNN. What have you heard about that?

Mr. GILLERAN. Well, my understanding of that is that there were some in the Department who were surprised and there were some that, you know, weren't. I think really where the Department stood is that they wanted to have the issue clarified.

Senator NUNN. Your department?

Mr. GILLERAN. The State Banking Department wanted to have the issue clarified. They were concerned about it, they raised it——

Senator NUNN. So that didn't bother the State Banking Department that that was changed then?

Mr. GILLERAN. I don't think so. In reality, I think that what happened was that the law was changed, that clarified the situation for them, and therefore that exception to their report was gone.

Senator NUNN. You didn't think there was any inherent risk here, your department didn't? In other words, it sounds as if the department was concerned more about the technicality than they were the real risk.

Mr. GILLERAN. I think that they wanted to satisfy themselves that FITCO was technically able to conduct the business as they were conducting it, and so therefore that law change then made it quite clear. I don't think that they were ever concerned overall about the nature of the kind of business that FITCO was in. I think that the department felt that the student loan program was backed by the Education Department and that the trust rate account holders would get their money back.

Senator NUNN. Do you have any other suggestions, in looking at it from the perspective your department has been involved, as to what should be done to see that this kind of thing doesn't happen again?

Mr. GILLERAN. Well, once we get the liquidation behind us and we get some more available time, I intend to make a more thorough review than I have made of the situation. But again, I can tell you my perception of this is that the State Banking Department worked extremely hard with this licensee to get them to correct their procedures and to do a good job for the public, and that it is a very unfortunate situation. Whether or not under the circumstances it could have been prevented, I just haven't been able to conclude that.

Senator NUNN. Mr. Gilleran, Mr. Evangelista in his prepared testimony speaks of—and he will be testifying in a few minutes, "animosity," by your department against FITCO, as well as, quote, "The intensity of the Banking Department's efforts to destroy FITCO," end quote.

What do you say about that? Do you find any evidence your department was basically out to get FITCO or had animosity toward FITCO?

Mr. GILLERAN. I haven't seen any of that whatsoever. I think that the State Banking Department tried very hard to do the job that it thought it should do. I think it was working with a licensee who was recalcitrant and uncooperative and resistant, and I could probably understand on that basis that comment from that gentleman.

Senator NUNN. Mr. Keefe.

TESTIMONY OF JOHN H. KEEFE, FORMER EMPLOYEE, DEPARTMENT OF EDUCATION [1]

Mr. KEEFE. Senator, my name is John Keefe. Your recent letter requested to me that I comment on a number of subjects. Each in itself is a long story, I will touch on each briefly.

Senator NUNN. Your entire statement will be in the record, without objection.

Mr. KEEFE. In 1974, I went to work for the Office of Guaranteed Student Loans in Region IX, San Francisco. We were responsible for monitoring the loan program in the States of Arizona, California, Hawaii, Nevada and the Trust Territories. Our staff consisted of a supervisor and 4 program officers. We issued commitments for loans, answered questions regarding the program from students, lenders and schools, and had the responsibility for monitoring the compliance of at least 800 lenders and half that many schools. When I retired at the end of 1988, Region IX had expanded to 14 States and we had a supervisor and five program officers.

Two things had a great impact on our ability to perform our mission. One was staff training, and the other the availability of travel funds. My training in 1974 consisted of being given an outdated manual, a set of regulations, and being taken on two program reviews. Over the years training was a hit or miss proposition. In the mid-1980s, Washington began to put training programs together which were helpful and enabled us to do a better job.

The other item I mentioned was travel. There were periods where there was no money for this. Without travel funds, we could not make reviews of lenders or guarantee agencies and hence were unable to do our job. What funds were available appeared to be directed to the campus-based programs. Often we traveled for the purpose of putting out fires.

One further point, between 1974 and 1988 the loan program changed significantly. First, loan volume expanded dramatically. The Federal Insured Student Loan Program was phased out and the guarantee agencies took over. Out-of-state lenders moved into Region IX, community college and proprietary students began to get access to loan funds in the early 1980s. Region IX always had a close working relationship with the guarantee agencies. With both the California Student Aid Commission and the United Student Aid Funds, we assisted in the training of their review staffs by conducting joint reviews with them, exchanging travel plans, and sharing our review findings. This free exchange of information did not take place with other regulators, whether it be Federal or State, with one exception. This is a deficiency which should be examined and corrected.

Senator NUNN. What keeps that from happening, Mr. Keefe? Is that a matter of law or is that a matter of regulation, or people just don't do it?

Mr. KEEFE. I think more than anything was people just don't do it, although there were some problems, again, with the releasing of information and releasing of our reports to other agencies. We would have to sanitize them, and by that I mean take out student names, Social Security numbers, and anything that would identify them, and which would really take the impact of sharing a lot of the information away.

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[1] See p. 410 for Mr. Keefe's prepared statement.

The First Independent Trust Company came to my attention in 1980 when they became a lender. In 1981, two of us visited FITCO for the purpose of making a program review. Our primary objective was to examine the interest and special allowance billings being submitted to the Department of Education. As I remember, there were no particular problems in that area.

Our primary concern was staffing. We told management there was no way two people could handle the work load. Once the loans went into repayment, additional staff would have to be allocated in order to do the necessary due diligence on the loans. From this point on we had regular contact with FITCO management. Generally it related to the difficulties they were having in increasing their percentage of the student loan program. They often asked our opinion on various marketing programs.

In late 1985 we first had a clue that there might be a problem at FITCO. During a visit to United Education and Software for another purpose, it came to our attention FITCO was not forwarding cancellations and refunds to UES promptly. Delays as long as 14 months were noted. This matter was brought to FITCO management's attention and they placed the blame on UES. UES provided us with a printout showing that there were in excess of 15,000 of these late items. My sampling indicated the loan holders had been paid in excess of $2 million in interest and special allowance because of these delays. FITCO management disputed this, blamed the delays on UES, and promised to look into the matter.

At this point in time we were without travel funds. Also, my staff was down to three program officers.

Senator NUNN. How much territory were you covering?

Mr. KEEFE. At that point still California, Arizona, Nevada, Hawaii and the Trust Territories.

Senator NUNN. And you had no travel funds?

Mr. KEEFE. No travel funds and three program officers.

Senator NUNN. What year was that?

Mr. KEEFE. That would be late 1985, 1986.

Senator NUNN. What could you do then? What really could you do? Did you just have to go through a paper drill more than anything?

Mr. KEEFE. Paper drill, and we really couldn't do anything except work by writing letters to people, getting them on the telephone, trying to encourage them to do something.

Senator NUNN. You couldn't go beyond the paper unless you got on the telephone?

Mr. KEEFE. Yes.

Senator NUNN. Did you do a lot of telephone——

Mr. KEEFE. We did a lot of telephone work, but again, it is not effective. If you cannot be there and put your hands on the records and look at them, you are not going to be able to do the job.

Senator NUNN. Did you tell anybody the woeful state of your capabilities?

Mr. KEEFE. Yes, we did.

Senator NUNN. Who did you report to?

Mr. **Keefe**. I reported to my immediate superior in San Francisco, the Assistant Regional Administrator at the time, and also to Division of Audit and Program Review here in DC.

Senator **Nunn**. Who were those people, do you remember?

Mr. **Keefe**. The Assistant Regional Administrator was Robert Crummel, the Division of Audit and Program Review I believe at that time was Carol Sperry.

Senator **Nunn**. Did they do anything with your recommendation that you know of?

Mr. **Keefe**. No, they did not.

Senator **Nunn**. They didn't go to the Department head?

Mr. **Keefe**. No. At that time what I did is, seeing that there was such a tremendous problem, I turned the whole problem over to ED's Inspector General for Audit in San Francisco and requested that they make an audit of FITCO. They did make an audit, and at the conclusion of their audit they came up with a liability on these loans of in excess of $1.1 million.

Senator **Nunn**. In other words, you knew you couldn't handle it so you turned it over to the IG?

Mr. **Keefe**. Right, because I knew we didn't have the staff to do it or the capability of doing it. I felt the IG was the best place to put the problem.

Senator **Nunn**. Did you feel there were other FITCO's out there that you just couldn't detect because of your inadequate staffing, travel funds, and so forth?

Mr. **Keefe**. Yes, we felt there were other disasters out there too.

Senator **Nunn**. Do you still feel that way? Do you think we have got some undiscovered time bombs ticking away here, or do you think most of them have come to light now?

Mr. **Keefe**. No. I think most of them have come to light. FITCO was a very unique situation. FITCO was a lender that originated loans, sold them immediately. They had no interest in holding loans. I doubt that there were probably more than one or two other lenders in the United States that operated in the manner that FITCO did.

Senator **Nunn**. Were you reporting problems you found with FITCO, just your cursory examination, to the Department of Education?

Mr. **Keefe**. Yes, all of our reports and program reviews were forwarded to Washington.

Senator **Nunn**. Did you get any response from Washington?

Mr. **Keefe**. Generally, no.

Senator **Nunn**. Did you know the California Banking Department had questioned the eligibility of FITCO?

Mr. **Keefe**. Yes, we did. However, not until about 1985 or 1986, that they questioned it.

Senator **Nunn**. Did they notify you, or how did you find out about it?

Mr. **Keefe**. They called us in the course of making a program review—or making one of their reviews at FITCO—they called us and questioned why FITCO was an eligible lender. Our answer was that we had determined that they met the qualifications of statutes back in 1980 or 1981 when we issued an identification number to them.

Senator NUNN. What kind of response did you get from Washington when you said that FITCO had problems?

Mr. KEEFE. I would say basically no response. There was certainly no direction to go in there and look at FITCO.

Senator NUNN. Did you put those warnings in writing?

Mr. KEEFE. I believe the file will show—yes, the file should show that there is some correspondence to that effect.

Senator NUNN. Do you have access to those files?

Mr. KEEFE. No, I don't.

Senator NUNN. Were you requesting that Washington take action, give you some direction or give you funds? What were you actually asking Washington to do?

Mr. KEEFE. What we were asking Washington to do was—what we were asking Washington was for guidance, what they wanted us to do.

Senator NUNN. And you didn't get any?

Mr. KEEFE. No.

Senator NUNN. What did you think about that?

Mr. KEEFE. Well, I think Washington probably didn't realize the magnitude of the problem, although we tried to make it clear to them what the situation was. But I think they had a lot of other problems on their hands. And also, in some of those years when we first had this coming up, as I mentioned earlier, the campus-based programs seemed to be the primary focus of the staff in DC.

Senator NUNN. Well, did you pick up the phone and call somebody and say, look, we got a disaster out here you better do something about it? I mean, how urgent were you in your request?

Mr. KEEFE. Well, probably not as urgent as we should have been. I think early on when this first broke we didn't really realize that the disaster was as big as it turned out to be. First of all, we were not aware—and again, this comes from lack of communication between the various regulators—of the precarious financial situation at FITCO. Our reviews were such that we never looked at the financial status of an institution. We went in—first of all, it wasn't in our area. We were looking at the loans and how they were handled. And secondly, we certainly had no expertise in analyzing the financial structure of any lending institution.

Senator NUNN. So you were really looking at the loans themselves?

Mr. KEEFE. Yes. All we looked at were the loans themselves, were they made in compliance with the statutes and rules and regulations, was the due diligence being done, were the interest billings to the Department of Education accurate.

Senator NUNN. You basically though, by your staff and travel restrictions, had to go through a paper drill on this didn't you?

Mr. KEEFE. Yes.

Senator NUNN. If you couldn't get behind the loans, you couldn't go into any detail?

Mr. KEEFE. No, we couldn't. A review, again, was generally a cursory thing. Our program was when we were in the field we tried to do two reviews in a week. So that meant that in a lender you would be there 2 to 3 days at the most.

Senator NUNN. Two to 3 days per lender?

Mr. KEEFE. Per lender.

Senator **Nunn**. How many lenders does that mean you can cover in a year?

Mr. **Keefe**. In a year our program officers I believe were supposed to make 24 program reviews, each program officer. So if we had four, we were going to make 96. Very frankly——

Senator **Nunn**. Out of how many total?

Mr. **Keefe**. Out of probably in the Region maybe 300 to 400 active lenders.

Senator **Nunn**. So a program review is of one lender, is that right?

Mr. **Keefe**. Yes.

Senator **Nunn**. So theoretically you were trying to make about 90 out of 340 a year?

Mr. **Keefe**. Yes.

Senator **Nunn**. How many in reality were you able to do?

Mr. **Keefe**. In reality we probably did about—I don't think any year we ever did what we were supposed to do. Most years it was probably down in the 50-60 range, and some years maybe even less.

Senator **Nunn**. So really, if things worked as you have stated, you would get around to a lender about every 6 or 7 years?

Mr. **Keefe**. That is about right.

Senator **Nunn**. I don't want to get ahead of your testimony. Why don't you go ahead, but I'm going to ask you in a minute what you think should be done. You have been out there in the field.

Mr. **Keefe**. Well, I think first of all you need ample staff to be able to accomplish the job.

Senator **Nunn**. How many staff people would you have needed to do it right?

Mr. **Keefe**. Probably at least double the number of staff we had.

Senator **Nunn**. And you told Washington that?

Mr. **Keefe**. Well, we did that for years. Yes, Washington was aware that we were short of staff. We weren't the only Region that was in that situation, all the regions were short. Also, I think it was important that the staff be well trained.

Senator **Nunn**. And your staff never had that kind of training?

Mr. **Keefe**. Not until probably about 1984 or 1985 did we begin to have a good staff training program.

Senator **Nunn**. You think it has improved now?

Mr. **Keefe**. Yes, very definitely. The training is much better now than it was. And I think, of course, again, as I say, the travel funds, and the time not to treat every lender the same. That if you did find problems and you were visiting a lender, the time should be there that if you need to spend an extra few days or extra period of time, you shouldn't be on such a schedule.

Senator **Nunn**. Did you ever tell Washington that FITCO owed the Department a lot of money?

Mr. **Keefe**. Yes, and I have that coming up. I will get to that later here.

Senator **Nunn**. Okay. Go ahead.

Mr. **Keefe**. During this period we did meet and discuss the situation with the State Department of Banking. The concerns that the State had, as far as we could see, was that the liability mentioned above would put FITCO in a deficit net worth position. This is the

$1.1 million owed to the Department. No firm conclusions were made. After this, we did have contact with the Banking Department on occasions.

In late 1987, CSAC advised Region IX that they were going to do a program review of FITCO in January of 1988. To assist CSAC, we ordered printouts of interest and special allowance payments made to FITCO. From these we determined FITCO had not filed reports in over a year. ED did not have a program at that time to monitor lenders who failed to file interest and special allowance reports. Two of us joined the CSAC staff to participate in the interest and special allowance portion of the review. While on-site it was estimated FITCO owed ED over $10 million in origination fees. FITCO was advised these reports had to be filed immediately and all fees paid. Over the next 6 months they filed all 1987 reports and paid ED approximately $13.3 million in origination fees.

Senator Nunn. "ED" being the Department of Education?

Mr. KEEFE. Yes.

Senator NUNN. They paid how much?

Mr. KEEFE. About $13.3 million in origination fees.

Senator NUNN. When was this?

Mr. KEEFE. They paid those between January and July of 1988.

In July 1988 the UES problem arose and the pressure on FITCO was relaxed because of our limited resources. The first two 1988 quarterly reports were not filed until 1989. However, the origination fees were never paid and are still due.

California Student Loan Finance Corporation began purchasing loans in approximately 1982. Under the statutes, they were not an eligible lender for the guaranteed student loan program. The lender of record for the loans they held was the Bank of America.

Senator NUNN. Now those origination fees are fees that have already been collected by the agency, right?

Mr. KEEFE. They are collected by the lender when he makes the loan. He takes 5 percent out of each loan.

Senator NUNN. The student has paid that?

Mr. KEEFE. The student has paid it and the lender is supposed to settle every quarter with the Department of Education.

Senator NUNN. Every quarter. Why is it so complicated for the Department? You have got a computer and it shows what is not in. Lenders are holding U.S. Government money and the taxpayers are losing interest on it, if nothing else. Why is it hard for the Department of Education to have a system that basically says you have got to pay and if you don't pay you are off the list? It seems to me that would not be very difficult. Some of these problems are hard, but this doesn't seem like a difficult one to me.

Mr. KEEFE. At the time the Department had no capability of monitoring if a lender didn't file. The only way the Department knew a lender would owe money was if the lender filed the report. If the lender did not file the report, as in FITCO's case, we had no knowledge that they owed us money.

Senator NUNN. What do you think of that system of management by a governmental agency?

Mr. KEEFE. Well, I think we certainly learned that it was a very poor system, that we should have some guidelines in there that if a lender doesn't file within a reasonable period after the end of the quarter that there is a follow-up to find out why he didn't file. Now I believe there is such a system in place.

Senator NUNN. It seems to me you could almost put it on automatic. If you don't get a report in, it kicks out a name and says the following didn't give a report. You send them a warning notice and in 30 days their eligibility is terminated if they don't pay.

Mr. KEEFE. That's absolutely right, it could be easily done.

Senator NUNN. Did you know that was happening out there?

Mr. KEEFE. No, we didn't know it was happening.

Senator NUNN. So really the reports are supposed to go to Washington, not to you?

Mr. KEEFE. The reports went to Washington.

Senator NUNN. So you wouldn't have any way of knowing?

Mr. KEEFE. No.

Senator NUNN. There was no system where the people in the field knew what Washington was getting or not getting?

Mr. KEEFE. Yes, we were not aware of whether Washington was getting the reports or not.

Senator NUNN. So we don't have a problem just communicating with other agencies. We have got a problem with lack of communication between the Education Department field and headquarters, right?

Mr. KEEFE. Right. FITCO was probably the first lender we encountered in the United States that owed origination fees that were greater than their interest and special allowance payments.

Senator NUNN. Usually there is an offset?

Mr. KEEFE. Usually it is an offset. So you might look at it this way, if you don't file your reports you don't get paid. And in many cases of course this is the situation. If a lender didn't file, we didn't have to pay him, and FITCO was unique in that they were the first lender of this type in the country, as far as I know.

Senator NUNN. Are there others, or is this still unique?

Mr. KEEFE. I think it is still unique. There may be 1 or 2 others. I think there was a bank in Kansas that was very similar to FITCO. Otherwise, most of the lenders hold enough loans so that the interest and special allowance payments due them exceed the origination fees. So as a result, that is an incentive for them to file their interest billings every quarter to get paid.

CSLFC marketed their program very aggressively and purchased loans other secondary markets put restrictions on. As a result, proprietary schools sought out lenders who would sell to CSLFC. Over a period of time FITCO became the largest lender in California and the prime source of CSLFC's purchases. As FITCO become a national lender, CSLFC began to purchase loans for students attending schools throughout the United States. The CSLFC loan portfolio was not reviewed by ED for various reasons. We had been told by ED in Washington not to review servicers as we had no legal authority to do so. They were not a participant in the program. Also, of course, staff limitations and minimal travel funds limited what we're able to do.

As time proved, the lender of record, Bank of America, was not monitoring what CSLFC was doing and being sure CSLFC was in conformance with the statutes and rules and regulations of the guaranteed student loan program. UES—United Education and

Software—and CSLFC have to be looked at as one entity. It was difficult to determine where one took over and the other left off. When there was a question, either could be contacted for an answer. If you called the lender of record, Bank of America, they would refer you to CSLFC.

UES had owned and operated schools for a number of years. They also had a servicing arm which serviced National Direct Student Loans. From this they expanded into the servicing of guaranteed student loans in about 1982. The success of CSLFC's marketing program caused it to grow rapidly. UES was unable to absorb this growth in an orderly fashion. From 1986 on, we began to receive a few complaints regarding the loan servicing at UES. As we were not the loan guarantors, the majority of such complaints went to CSAC and the other guarantors. CSAC and Region IX did discuss the problem. Both of us brought these concerns to the attention of the managements of UES and CSLFC. In all cases the individual problems were resolved. We were assured that with new computer equipment and new larger facilities these problems would soon be resolved.

As we determined in 1988, this was not the case. A review at UES in June of 1988 indicated the situation was out of control. There were literally hundreds of boxes of unfiled correspondence dating back many months. As a result, students were being deprived of their rights provided them by the program and due diligence was not being performed on the loans. There was also a concern that collection records were being falsified. For example, collection histories indicated final demand letters were sent on a specific date. Investigation showed they were never sent. Collection histories showed long distance telephone calls were made, but examination of telephone records did not substantiate this. A joint review team from the two guarantors and ED visited UES the last week of July 1988 and verified the above. This resulted in ED refusing to reinsure all loans serviced at UES.

Senator NUNN. You mentioned that you told someone in the management of UES about the problem, is that right?

Mr. KEEFE. Yes.

Senator NUNN. Do you remember who that was?

Mr. KEEFE. We talked to the people in Costa Mesa and also correspondence was directed to Mr. Cohen concerning——

Senator NUNN. You didn't talk to Mr. Cohen directly?

Mr. KEEFE. Yes.

Senator NUNN. You did talk to him directly?

Mr. KEEFE. Yes, I talked to Mr. Cohen.

Senator NUNN. On the phone or in person?

Mr. KEEFE. On the phone.

Senator NUNN. And you also corresponded with him?

Mr. KEEFE. And we also sent copies of complaint letters and correspondence to Mr. Cohen asking that he see they be straightened out.

Senator NUNN. What did he tell you in response to your complaints?

Mr. KEEFE. Well, as I mentioned, the individual concerns were always solved and that they had new equipment on order, they were moving to larger and more spacious facilities.

Senator **Nunn**. In other words, he acknowledged the problems and said he would correct them?

Mr. **Keefe**. Acknowledged the problems but they knew that they were on the way to correcting them.

You requested also in your letter that I comment on the relation between headquarters and the regional office. As I mentioned earlier, the emphasis in my first years was on the campus-based programs, the student loan program was not the number one priority. The headquarters staff was always hard to reach for advice and guidance. I feel this was due to the demands being made upon their time and not due to any particular indifference. When the Office of Student Financial Assistance was reorganized in approximately 1986 the situation improved greatly.

I appreciate this opportunity to express my thoughts. If you have any questions, I would be pleased to respond.

Senator **Nunn**. Mr. Keefe, thank you very much for your testimony. What do you do now?

Mr. **Keefe**. I am a consultant in the student loan program and have been working for the last 15 or 16 months with the State Department of Banking helping them straighten out the situation at FITCO.

Senator **Nunn**. You are working with the California State Department of Banking?

Mr. **Keefe**. State Banking Department, yes.

Senator **Nunn**. And you are also doing what?

Mr. **Keefe**. Other consulting work in the student loan area.

Senator **Nunn**. Who do you consult with, lenders or the guarantee agencies?

Mr. **Keefe**. Lenders primarily.

Senator **Nunn**. You help them with the technical details?

Mr. **Keefe**. Yes, with technical details. If they have had some problems with their interest billings, trying to get them straightened out, or in some cases if they have had problems maybe responding to the departmental program review, helping them answer their questions raised.

Senator **Nunn**. Looking back on it, how could this kind of mess have been avoided? Not just with FITCO, but with the whole proprietary industry and the whole array of problems in the student loan program?

Mr. **Keefe**. I think you would have to go back to the great increase in the number of schools and the type of schools that were let into the program, which I don't think was what we envisioned when the program first started. I think, secondly, the way—and probably I think a big thing—was in the 1970s—and I can only speak for Region IX—when students wanted a loan they went to the bank and they got the loan. They went down and they sat with a bank officer. Say, for example, Bank of America had in California probably 75 offices which issued student loans, and the student knew he had a loan. When the Eastern banks—or I shouldn't—or out-of-state banks moved into California, it became a mail order business. The school filled out an application, they sent it to some bank, the student had no idea, and whether it came in from California or otherwise, the idea that the student had to go in and talk to a banker he knew he had a loan. And I think the personal thing dropped out of it and it was I think wrong.

Senator **Nunn**. In other words, you take away any accountability on the part of the student. It just becomes too routine, too easy, and there is not the realization that they actually owe the money.

Mr. **Keefe**. That's right. I mean, how would a student in Ohio know to get a loan from FITCO except that some school was directing him there?

Senator **Nunn**. What about the quality of the schools? We have heard over and over again that a substantial number of proprietary schools are basically—not all of them—not interested in education at all and therefore do not provide quality education.

Mr. **Keefe**. That is right. We used to refer within the Department that we had schools that we called "sold seats," and as soon as a student was in school, beyond the refund point, the students were—nobody cared whether they came back, and that was, generally speaking, 50 percent of the educational period went by and the student was——

Senator **Nunn**. Just get the money and that was it.

Mr. **Keefe**. Get the money, and then if they didn't——

Senator **Nunn**. What did you call them?

Mr. **Keefe**. We said the school sold seats.

Senator **Nunn**. Sold seats. I see.

Mr. **Keefe**. And once a student was beyond the refund period they didn't care whether he came back or not.

Senator **Nunn**. Did you know that while you were with the Department of Education?

Mr. **Keefe**. Yes, we knew that.

Senator **Nunn**. What did you do about it?

Mr. **Keefe**. Well, of course, we tried to talk to schools about retention rates and graduation rates and so on, but the regulation didn't really give us a lot of teeth to do anything in that area, number one.

Senator **Nunn**. You didn't feel like you could do much?

Mr. **Keefe**. No.

Senator **Nunn**. Did you tell anybody in Washington about that?

Mr. **Keefe**. Yes, Washington was aware. I mean, we weren't the only Region complaining of this.

Senator **Nunn**. But who did you tell about this? I mean, did you tell your supervisors up the line?

Mr. **Keefe**. Yes. Well, I might say this, we had very little—after the early 1980s we became more departmentalized and we had very minimal contact with schools. Our concentration was on lenders and on guarantee agencies from that point on.

Senator **Nunn**. But you knew what was happening?

Mr. **Keefe**. We knew what was going on.

Senator **Nunn**. And Washington knew what was going on?

Mr. **Keefe**. Yes, I think Washington was well aware of it.

Senator **Nunn**. Why do you think a department in charge of education would sit there and let this go on, knowing it, without trying to do something about it?

Mr. **Keefe**. I think they did through various changes in the regulations over the years. They did try, but I think it was a very difficult problem. The regulatory process in itself is very involved, as you know. It takes a tremendous period of time to get regulations published and, of course, anything that in some ways would restrict schools and their participation in the program was vigorously fought by various agencies.

Senator NUNN. Fought by strong political interests?

Mr. KEEFE. Yes.

Senator NUNN. If the California State Banking Department had not closed FITCO, do you think the Department of Education would have stopped FITCO's participation in Federal guaranteed student loan programs?

Mr. KEEFE. Yes, I think probably so. Had we not received that $13 million, I think we would have taken steps to suspend FITCO. As it was, I think two of the guarantors had already taken steps to put a stop to FITCO's participation in the program.

Senator NUNN. Mr. Keefe, Mr. Evangelista told the staff that when FITCO's origination fees first exceeded the interest benefits and special allowance payments, FITCO sent a check for approximately $16,000 to the Education Department but the Department, according to him, returned the money, citing a lack of procedures to receive such monies. Does that make any sense to you? Could that have happened?

Mr. KEEFE. I am not aware that it did happen. I certainly have no knowledge of it. I think it is very possible that it could have happened, but I am not aware of it. You know, it was difficult for the Department to accept funds if we didn't have a liability to offset them with. But again, that was handled through Washington and not at the regional level.

Senator NUNN. That wouldn't have come to your attention?

Mr. KEEFE. No, it would not have come to my attention.

Senator NUNN. In other words, you think at the Washington level during this time frame, it was very difficult for them to receive money as they could only net out?

Mr. KEEFE. Yes. If they didn't have something to offset that $16,000 with, I guess it would be difficult for them I guess to apply it.

Senator NUNN. But when somebody drops a check in the mail and sends $16,000 to a Federal department and they say they owe the money, you would think somebody would try to determine how the Government could keep it.

Mr. KEEFE. I would think so.

Senator NUNN. I would think that is what the taxpayers would expect, wouldn't you?

Mr. KEEFE. I would, yes. I would think even if you had to put it in suspense until you figured out what to do with it, it would be a good place to put it.

Senator NUNN. Mr. Keefe, thank you very much. We appreciate you and Mr. Gilleran being here today. Thank you.

Our last panel of witnesses represents principal players in the case study. Mr. Trent Nebeker is a Vice President of California Student Loan Finance Corporation, CSLFC, in Los Angeles, California. Mr. Nebeker, a former official with the student loan department of the Bank of America, has been with CSLFC for several years. Aaron Cohen is the former President of United Education and Software, the firm that was responsible for servicing the

CSLFC student loan portfolio. I believe Ms. Gretchen Staff is the former Vice President of UES and oversaw the student loan servicing operation. And Mr. Deno Evangelista is the founder and President of the First Independent Trust Company, about which we have heard a great deal in the last two days. Mr. Evangelista's trust company grew to become the Nation's second leading lender in the origination of federally guaranteed student loans.

We welcome all the witnesses this morning. I will ask each of you to raise your right hand. We give the oath to everyone that testifies.

Do you swear the testimony you give before the Subcommittee will be the truth, the whole truth and nothing but the truth so help you God?

Ms. **Staff**. I do.

Mr. **Nebeker**. I do.

Mr. **Cohen**. I do.

Mr. **Evangelista**. I do.

Senator **Nunn**. I believe, Ms. Staff, that you don't have a statement and that you are going to be responsive to questions? Is that correct?

Ms. **Staff**. That's correct.

Senator **Nunn**. Mr. Evangelista, would you like to lead off this morning.

TESTIMONY OF DENO EVANGELISTA, PRESIDENT, FIRST INDEPENDENT TRUST CO.[1]

Mr. **Evangelista**. Thank you very much, Mr. Chairman. My name is Deno Evangelista and I am Chairman of the Board and founder of First Independent Trust. I appear here, and I'm welcome and happy to be here, and I come without counsel, although counsel for the corporation is here.

Senator **Nunn**. Do you have counsel with you?

Mr. **Evangelista**. No, sir. I have submitted my letter to you as you requested, and I request now that this letter be placed into the records of these proceedings, and from all of the stories I have heard, I am going to make another request, and that is that you permit me to later on give you in writing additional material to be added to all of the stories that I have heard.

Senator **Nunn**. We will do that. Mr. Evangelista, you are entitled to counsel if you would like to have counsel with you. I just want to make sure you understand that.

Mr. **Evangelista**. Oh no, sir, I will have no problem, Mr. Chairman.

What I heard here, however, is unbelievable. I just can't believe that the largest lender in the student loan program in the United States and in California is the downfall of all of these stories that I have heard. Just because a regulator says something doesn't make it true. Casting stones isn't going to solve this problem. And the problem that FITCO encountered was also encountered by others.

After hearing the testimony that I have heard this morning so far, I am not going to go on, because I am going to ask you to ask me the same questions that you asked the people yesterday—and I hope you have the questions you asked yesterday—and the questions that you were asking today I would like to give you FITCO's side.

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[1] See p. 420 for Mr. Evangelista's prepared statement.

But before I do that, Mr. Chairman, I do want to read to you that when these problems arose I just wasn't going to sit there and not do anything about it. I have a letter from April 21, 1989, from my chief financial officer on the problems that were encountered. I am not going to read the report. You can have a copy of the report, but I am going to take some paragraphs out that are important to you.

He is telling me, "as you are aware, beginning in December 1988 HEAF and CSAC both began to bring forward serious issues relating to the manifesting of payments of guaranteed student fees." Well, FITCO requested information on all the loans and their status from HEAF's loan system. "With the information from HEAF's system, FITCO prepared a reconciliation of the two databases and began to manifest the corrections of the HEAF system. FITCO spent an excess amount of time accounting for 169,000 loans that were not originated by FITCO. The extra records represent some form of processing error by HEAF". "When FITCO attempted to manifest these cancellations, we found that it was HEAF's policy that cancellations can only be processed by a lender of record," and that created a great big problem.

I can tell you that HEAF's mechanical and system is completely out of whack because there is no way for them to send us 169,000 loans that are not ours and expect to be paid insurance fees and whatever have you.

My information to me continued, that the transaction except rejection reports are not a regular part of HEAF's manifest process so the ability of the lender to determine the status of the manifest submitted is left to the past due report to reflect that at the end of the quarter. The past due report would not reflect the cancellation that had been accepted.

Now, in reference to Mr. Kipp and CSAC, my staff tells me the problem with CSAC primarily focuses on the manifesting of loan origination fees. FITCO was then assigned the responsibility of past due reporting to resolve the problems. In order to work the past due report the California Student Aid Commission requested, it was necessary that FITCO create a data base. Again, FITCO invested over 2,000 hours of time to create this data base. FITCO generated the manifest to begin the correction of the past due report. It was after FITCO submitted the first correcting report that CSAC asked for $40,000 to clear a manifest submitted to them. After the $40,000 were received, CSAC then informed FITCO that CSAC was holding in excess of $200,000 in fees and related manifests. This would substantially change the direction of FITCO's manifesting project. When CSAC was asked why they did not inform FITCO of the pending transaction at the outset of the project, CSAC apologized and indicated they were not aware of the problem themselves.

So, once again, the stories that I heard of—all of these bad stories of numbers and not paying this and not paying that, I think someone should be looking at, as I said into your report, take a look at their manifesting.

CSAC has also indicated in their compliance review that they are concerned over the number of times in rejection of reports. It was found that when manifesting class loans that transactions were rejecting due to "computed fee invalid." FITCO researched the situation and found that CSAC's system is not properly retrieving the fee transmitted with the guarantees and therefore believes the fee being paid by FITCO to be invalid. These rejections reports are the largest time consumer in the student loan process. The failure of CSAC to accept the fee magnifies into a bad reflection on the lender.

Now, one of the individuals who was doing the real work, Larry Schlieger, I asked him for a report on these unapplied premiums. When loan insurance premiums were rejected or canceled through the manifest process, CSAC kept all the related funds even though they did not apply to the premiums to any loans. While a report was issued at the time of each remittance, there was no cumulative accounting of funds held and no property applied for by CSAC. Many thousands of dollars of unapplied insurance premiums remain in CSAC's possession. And by the way, I wrote a letter requesting an accounting, which I never did get.

CSAC is placing the responsibility for their system failure on the individual lenders. In order for us to deal with this problem, we need a complete accounting of all the premiums paid prior to 1988 and a list of which premiums have and which premiums have not been applied to the intended loans. Since we have no accounting prior to 1988, the fees owing became a problem. FITCO's only efficient solution to take was to make a duplicate payment and then hope that we were able to recover the funds after proving to CSAC that we had paid the premium twice.

So all of this that I have heard so far has been very, very—the throwing of these stones in terms of the records is very disturbing to me. Now, I have Dave Patterson who worked for CSAC, and he was in charge of the class program. And here is what we wrote to CSAC.

"Most of our class rejects for the last few 410 reports have given a reject reason of 'computer fee invalid.' Samples of these reports have been matched to the CSAC loan system. The fees match according to the system. Attached are a few samples". "Please review and let me know if this is a problem on your end" or not. And then they come back and tell us it was their problem, and that was it.

Now, I just want to make a couple of other points, Mr. Chairman. FITCO is not responsible for this fiasco. I don't believe, what I heard in here, anybody understands what FITCO did or what it does, and I don't believe anybody understands that there are two parts—and I heard the superintendent talk about the trust side being accurate, and if the trust side is accurate, then Mr. Voelm ought to get his money. There has been nothing done, Mr. Chairman, by FITCO that has prevented the United States Government from receiving—going back to Mary Jane Smith and collecting on that money, and they have the proper documentation in order to get it. Mary Jane out there still owes the money, and somebody should be going after that.

So when I hear these words these students loans are valueless and all of these negative things, it is very disturbing, because there is a student loan and what was done did not release the insurability. So the question here is if the trust account, as they reported to the court, is whole, then why aren't they paying Mr. Voelm?

So that is the problem. The problem here is that we were using trust assets to make student loans, and those assets belonged to a trust. And there is no one can come in and invade a trust and have a trust pay for the corporate errors that a corporation may make.

If the trust had General Motors in it and the trust did not receive the dividend check, the bank would not put the dividend check into the trust, it would have to go after the General Motors and get the dividend check. Trust rate is misunderstood. Trust rate only means that you have directed me to go into student loans. You could have directed me to buy gold. You could have directed me to buy mortgages. You could have directed me to buy anything you wanted to buy, so long as it was legal. So we have a directed trust. And what people signed—and I don't know that 15 page article that was sent up—but what people signed was a trust instrument, and in order to get this trust instrument, Mr. Chairman, it was reviewed by the most prominent counsel in California.

I asked the California Bankers Association to give me the best counseling that there was in all of the areas that have to do with student loans, trust, banking, and whatever have you. Out of that group I got 11 attorneys, three of them I never saw. We spent hundreds of thousands of dollars trying to prove whatever they are trying to prove and none of these attorneys have come back and told me that we were in error.

You asked a question of harassment that I mentioned in the letter. We had to reply—I noticed in one of the reports here that the term "91 days" is used in the payment by the United States Government to a lender. Would you believe, Mr. Chairman, that that was a big argument and a big discussion that I had with the Banking Department, That I was misinforming people by using the word "91-day Treasury bill"? The word "91-day Treasury bill" is used in one of your reports that one of your staff members made, and if you go through the education act you find 91 used. Nevertheless, the Banking Department felt that using what was in the law, 91 days, was false and misleading.

Senator NUNN. Well, Mr. Evangelista, let me ask you a question here at this point. I have been using the word "disaster" while you use the word "fiasco," but I think we are on the same wave length. We have got a bad problem here. Who caused it? Who caused the fiasco?

Mr. EVANGELISTA. It was caused by everybody. Everybody caused the fiasco. It starts because the schools themselves were not getting properly treated. If you recall in my report I talked about mathematical bigotry. Now, what did I mean by that, Mr. Chairman? What I meant by this, and I think Jack Keefe kind of mentioned on it, that the State of California at the beginning in the 1980 and 1981 and 1982 and 1983 was relying on two New York banks to come up with the money to educate the students in California. I thought that was a lousy shame. And this bigotry, this mathematical bigotry I come up with, that term basically means that we had banks that would say we will not make a student loan unless you have a 3 point average. We had banks that would say we will not make a student loan unless you have a 5-year banking relationship. And so we have minority people not being able to get student loans and that was the intent of the Congress.

Senator **Nunn**. And that is the reason you moved in?

Mr. **Evangelista**. Yes, we moved in.

Senator **Nunn**. Okay. And then came about this fiasco that we are looking at now, and I guess my question again to you is what caused the fiasco?

Mr. **Evangelista**. The fiasco really started with what happened with the Bank of America. The Bank of America and down at UES and the taking over of UES by them, the failure of them to properly apply the proper monies to the proper letters of credit, and the fact that you have 10 Japanese banks, the 10 largest banks in the world, suing the Bank of America. That is one of the things.

Senator **Nunn**. You are saying the number one problem was the Bank of America?

Mr. **Evangelista**. I can't enumerate them number one.

Senator **Nunn**. Well, they are in the group then?

Mr. **Evangelista**. In the group, yes.

Senator **Nunn**. Let's go on to who else is at fault.

Mr. **Evangelista**. What is wrong is the fact that there are no provisions that really look at these schools. The schools, if you are accredited that is all that is required, and you go to a school that is accredited, and it doesn't make any difference whether you are a barber or a beautician or a doctor or a lawyer, if you go to an accredited school you get a student loan. And we were the people, and the only people in California, who said we make student loans to anybody who goes to an accredited school irrespective of color, creed, race and whatever have you.

Senator **Nunn**. At the time were you worried about the quality of education? You seem to say that the accreditation process is a problem, and I would certainly agree with you on that. In other words, the students weren't getting a quality education in many of these schools, correct?

Mr. **Evangelista**. Right.

Senator **Nunn**. And that is one of the other problems here. Did you know that during this 1980's time frame, when you were making about 98 percent of your loans to proprietary schools? Did you know there was a quality of education problem?

Mr. **Evangelista**. Well, no and yes, Mr. Chairman. First of all, once I got into the program I only could do one of two things; I either got out of the program, or if a student sent his application to me, I could not tell him you are going to a school which is bad, because I would have a lawsuit from the school, or I would have to tell the student, you are a black, you are a Mexican, or whatever thing I might want to have a reason and not make a loan. So all I was abiding by was the law that the individual was going to an accredited school, I had a student loan which was guaranteed by the guaranteeing agency, and that is all the requirement that I had.

Senator **Nunn**. Okay. Let's go on down the list. The Bank of America is one problem. The accrediting agencies are another part of this fiasco. What else comes to mind?

Mr. **Evangelista**. The other problem really is here in Washington, DC, and I am talking about Sallie Mae.

Senator **Nunn**. About?

Mr. **Evangelista**. Sallie Mae.

Senator **Nunn**. Sallie Mae.

Mr. **Evangelista**. I believe that Sallie Mae has played a big part in this fiasco once again. Let me tell you my experience in meeting Sallie Mae. Maybe in 1981 or 1982 they come to visit me. And I sat down with them and they told me all of the good stuff, and they finally told me that in order for them to buy, the loans would have to average $4,200. At that time I told them I couldn't do business with them, because mathematically there is no way to make a student loan to a student for $1,000 and make $10 million or $20 million a package and send in and have an average of $4,200.

Senator **Nunn**. In other words, they didn't want to deal with little loans?

Mr. **Evangelista**. That's exactly right. They came back maybe a year later and they were seated at the conference room and I was told that some people from Sallie Mae were there. I walked in, I stood, I didn't sit down, I asked the question, is your procedure still a requirement that the average note has got to be $4,200? And they said yes, I said arrivederci.

Senator **Nunn**. Okay. We got Sallie Mae. That's three. Who else is at fault here?

Mr. **Evangelista**. Who else is at fault? The whole banking situation. I visited the banks up in the northern part of California and I told them, why don't you get into the student loan business? And the answer is, why should I get into the loan business, they are never going to come back here. Not enough banks participating. It is unbelievable that for the years of 1983–84 of the academic year, 1984–85 and 1985–86 I was the only bank making student loans in California in the PLUS loan program. I made the first PLUS loan program and I made more PLUS program loans than all the other two major lenders combined, and for 3 consecutive years I was the only one performing that function.

Senator **Nunn**. In other words, nobody else was in there and you were filling a big vacuum?

Mr. **Evangelista**. Yes, sir.

Senator **Nunn**. Okay. Let's go down the list again. Have you got anybody else that was at fault in this fiasco?

Mr. **Evangelista**. I heard that same question, you asking that same questions to others, Mr. Chairman. I will make sure that my memorandum to you that will come in will cover it.

Senator **Nunn**. You can supplement it for the record. Those are the ones that come to your mind,

Mr. **Evangelista**. Yes, at this point in time.

Senator **Nunn**. Okay. In your written statement you mentioned the California Banking Department and that they were basically after you unfairly. That they had animosity toward you. Are they on that list as part of the problem that led to this fiasco?

Mr. **Evangelista**. In the fall of FITCO?

Senator **Nunn**. Yes.

Mr. **Evangelista**. Yes. Positively.

Senator **Nunn**. What did they do unfairly to FITCO?

Mr. **Evangelista**. What they did unfairly, Mr. Chairman, is what the superintendent told you. You asked him questions and his replies were not there that satisfies what I would tell you. That there are two sides to First Independent Trust Company. There is the trust side, and the trust side has the money. Now, the idea that there is a problem on the corporate side has nothing to do with the trust side. Now, when Jack Keefe was just talking just awhile ago, he was mentioning the visit that he came and visited—well, your question, first of all, before I get to Jack.

The big problem that I had——

Senator NUNN. I am really asking what did the State Banking Department do wrong from your perspective.

Mr. EVANGELISTA. The problem started when they said we were not an eligible lender. If we were not an eligible lender, Mr. Chairman, then we were not a bank. And the question is—and we had to sue them and go into court as to whether or not what is a bank.

Now, under the definition of a bank under the financial code it says that a bank is: [A] commercial bank; [B] trust company. A good syllogism is a bank is a commercial bank or a trust company. FITCO is a trust company. Therefore FITCO is a bank, and I will argue that syllogism all day long.

Private counsel, more than one, in the area of this area have written me, and I have their letters that say that we are a bank. Now, if we are not a bank, then we would not have been an eligible lender. And we were a bank, but the Banking Department, when we went to court on one hearing, and continuously insisted that we were not a bank and purposely was holding back one thing, that their own attorney general told them that it was a bank because if we were not a bank and an eligible lender, then I can tell you that the California State Student Aid Commission sold $125 million of what I call toilet paper. Because it would not have been proper. The prospectus says that FITCO was the eligible lender, and it was under that that I made the class loans with.

Senator NUNN. But they didn't close you down on that basis did they?

Mr. EVANGELISTA. No, but there's your——

Senator NUNN. That was a problem, but that somehow got ironed out after you went to court, right?

Mr. EVANGELISTA. No, it is not ironed out yet.

Senator NUNN. They are still saying that you were never an eligible lender? Why did they close you down?

Mr. EVANGELISTA. Well, they closed me down because they said impairment of capital, and I disagree.

Senator NUNN. You think you had enough capital?

Mr. EVANGELISTA. I still had 19 days to meet the capital requirements. We were talking about $93,000, Mr. Chairman.

Senator NUNN. You could have done it if they hadn't closed you down?

Mr. EVANGELISTA. Mr. Chairman, the record will show that over the years, while there are stockholders, I personally put my own money in there without going to the stockholders to tell them when there was an impairment. I kept a close tab on that. There was no problem in raising $93,000.

Senator NUNN. How much did you put into FITCO of your own money?

Mr. **Evangelista**. Well, I will tell you what I lost in FITCO, all of the loans that I made to it. It probably amounts to close to $400,000 to $500,000.

Senator **Nunn**. During that time, let's say in the last 10 years of FITCO, how much did you draw out of FITCO?

Mr. **Evangelista**. That's a good question. On a yearly basis, I think there were a number of years where I got a dollar a year.

Senator **Nunn**. Wasn't there a parent corporation that you were getting money from?

Mr. **Evangelista**. No, sir. The parent corporation, Mr. Chairman, I had borrowed $110,000 from a local bank and I paid interest for about 10 years on it with my own money because it didn't have capital to meet its obligations.

Senator **Nunn**. Do you know over the last 10 or 12 years how much you have gotten out total? You got a dollar a year some years. What was the compensation in other years? What was the most you got out in any one year? Do you remember that?

Mr. **Evangelista**. I think the most is probably $200,000 when we had that good year that we made millions of dollars.

Senator **Nunn**. What year was that, do you remember?

Mr. **Evangelista**. Probably 1987. I'm not sure though.

Senator **Nunn**. Did you receive any salary or compensation from the Lawyers Financial Group or any other entities you control or had an interest in?

Mr. **Evangelista**. No. I just mentioned that it had no money. That is why I was coming up with the payment of the interest on the loan that the parent company had. And the Banking Department knew about that.

Senator **Nunn**. So the only money you got out of FITCO was what FITCO directly paid you, was there was any indirect parent or subsidiary corporation that you drew salaries out of?

Mr. **Evangelista**. No, sir. I supported both corporations.

Senator **Nunn**. Could you furnish for the record all the compensation you got from FITCO in the last 10 years?

Mr. **Evangelista**. I would be most happy, but I do have a problem. The problem is that since May 19th the Banking Department has never talked to me. The records will show it. We will have to get them. So let's ask the superintendent to go through the records and pull it out. No problem.

Senator **Nunn**. Looking back on it, what mistakes did you make as FITCO's manager?

Mr. **Evangelista**. I don't know if I made any mistakes. I guess we all make mistakes to a degree. I hear things that are not so. All I did was made student loans as provided, with no restrictions, to Americans who wanted to advance in life.

Senator **Nunn**. So really you didn't make any mistakes from your perspective?

Mr. **Evangelista**. No, sir.

Senator **Nunn**. Well what caused this operation to go broke?

Mr. **Evangelista**. The Banking Department intended it to go broke from the very beginning.

Senator **Nunn**. In other words, the State of California Banking Department set out to do you in?

Mr. **Evangelista**. You better believe it.

Senator **Nunn**. Okay. Do you want to add anything else. I am going to come back with some other questions, but I was going to go ahead to the other two witnesses and then come back.

Mr. **Evangelista**. Yes. I wish you would come back and ask me the specific questions you asked others, Mr. Chairman.

Senator **Nunn**. We will have a good many. Let me defer to Senator Roth for questions now to you, and then we will go to Mr. Cohen and then Mr. Nebeker.

Senator **Roth**. Thank you, Mr. Chairman.

Why did you make it a habit not to pay origination fees to the Department of Education? Weren't you aware that the fees were not being paid?

Mr. **Evangelista**. The origination fees?

Senator **Roth**. Yes.

Mr. **Evangelista**. More than one occasion we sent in the origination fees, as Mr. Keefe mentioned, and they were returned. It wasn't a habit. Whenever we had a meeting that he mentioned where they talked about a check of $13 million, at that time they were talking about $11 million. I said, okay, here, I called for the secretary to give them a check, I would have written him a check for $12,000,000 even though it was less. I said, if it is more, just give me some credit for it. Jack said, I can't take it. Whenever they billed me, I paid it within the prescribed time.

Senator **Roth**. Didn't the Department of Education from 1984 to 1989 inform FITCO that the fees had not been paid and how to go about doing it?

Mr. **Evangelista**. They never really informed us, because we always had excess money to pay them.

Senator **Roth**. Weren't you at one time in arrears $16 million in origination fees?

Mr. **Evangelista**. Not that I recall sir.

Senator **Roth**. You don't recall that?

Mr. **Evangelista**. No $16 million, no.

Senator **Roth**. What figure do you recall being in arrears?

Mr. **Evangelista**. Well, it went from $11 million, and by the time they billed me we got up to $13 million.

Senator **Roth**. You made loans to students at a great number of schools. Did you ever feel it was necessary to check the quality of the schools before granting the loans?

Mr. **Evangelista**. That was not a requirement, sir, of the law.

Senator **Roth**. Don't you think it would have been in your interest and the interest of those making the loans to have checked the quality of the schools?

Mr. **Evangelista**. Well, in the State of California I believe you have 2,000 schools, sir, and that is a lot of schools.

Senator **Roth**. What percent of your loans were to proprietary schools?

Mr. **Evangelista**. The largest percentage was proprietary schools, and not to my wishes.

Senator **Roth**. Was it 97 percent?

Mr. **Evangelista**. I would have liked to have made, sir, a lot more student loans to Stanford students and other students too. They just for some reason never came.

Senator **Roth**. Weren't 97 percent of your loans to proprietary schools.

Mr. **Evangelista**. I don't believe it was 97 percent. It was a substantial number.

Senator **Roth**. What do you recall it being?

Mr. **Evangelista**. I really can't answer that question. I don't recall sir, other than it was substantial.

Senator **Roth**. A provision was inserted in the 1986 reauthorization bill of the Higher Education Act which states that an eligible lender cannot, "have as its primary consumer credit function the making or holding of loans made to a student under this part unless it is a trust company which makes student loans as a trustee pursuant to an expressed trust and which operated as a lender under this part prior to January 1, 1981."

That's on the chart in red.

Mr. **Evangelista**. Yes.

Senator **Roth**. Wasn't this clause specifically drafted to let FITCO break the 50 percent quota for dealing in student loans?

Mr. **Evangelista**. No. I think when you say, sir, make it possible for FITCO to break the 50 percent rule, I don't think we ever broke the rule. We were using trust assets, and the trust doesn't have a 50 percent rule and that's where the discussion comes out. We were making student loans under that provision of the code that says that a lender can use its own money or trust assets if it is designed for that purpose, and that is exactly what we did. We took Keogh money, IRA money, all kind of monies and made student loans with them.

Senator **Roth**. Isn't it true that if you had not gotten this legislation the bank board would not have permitted you to continue to make loans, so that this language was in your interest?

Mr. **Evangelista**. The Banking Department would not have continued. The Banking Department had a problem all along with me in the student loan program because they claimed we were not a bank.

Senator **Roth**. Wasn't the purpose of this provision in the legislation to avoid that problem?

Mr. **Evangelista**. To a degree, to satisfy and avoid the problem, yes.

Senator **Nunn**. Answer "yes" or "no." Wasn't it for that purpose?

Mr. **Evangelista**. Yes.

Senator **Roth**. How did you get this special clause included in the reauthorization bill?

Mr. **Evangelista**. We hired a counsel in Washington, DC here to work on it.

Senator **Roth**. Who was that counsel?

Mr. **Evangelista**. Can I—whatever it is, I have a little problem in remembering the name sir.

Senator **Roth**. You will submit that in writing?

Mr. **Evangelista**. Yes. We had two of them.

Senator **Roth**. Did you or your representatives talk to anyone besides the law firm? Any members of Congress?

Mr. **Evangelista**. No.

Senator ROTH. None at all. When FITCO was seized by the California State Banking Department in 1989, what percentage of your business was in student loans?

Mr. EVANGELISTA. Of all of the business of FITCO?

Senator ROTH. Yes.

Mr. EVANGELISTA. FITCO was very unique, and one of the most disappointing factors to me, after working 5 years sir, I had formulated a plan in which SSI money was going to be directed to FITCO and we in turn would give this money out to the people out in the streets. My method of distribution of SSI money was very interesting. As a matter of fact, it got into the Office of——

Senator ROTH. Sir, my question is a very simple one. What percentage of your business was in student loans when FITCO was seized by the California State Banking Department in 1989?

Mr. EVANGELISTA. Approximately 60 percent.

Senator ROTH. That is all, Mr. Chairman.

Senator NUNN. Thank you. We will come back with some other questions, Mr. Evangelista.

Mr. Cohen, we will go to you now.

TESTIMONY OF AARON COHEN, PRESIDENT, UNITED EDUCATION AND SOFTWARE [1]

Mr. COHEN. I appreciate this opportunity to appear before the Subcommittee on Investigations. To the extent that the Subcommittee's work will result in recommendations for improvements in the guaranteed student loan programs designed to reduce fraud and abuse the taxpayer will be well served. To the extent that the Subcommittee's recommendations improve access and opportunity to quality education and training, all students, and particularly disadvantaged students, will be well served.

As the former President and Chief Executive Officer of United Education and Software, Incorporated, I have witnessed first-hand the evolution of the GSL program over nearly two decades. As one who headed a publicly owned corporation during a 5-year period when one of the corporation's subsidiaries provided loan servicing and loan application services to some of the Nation's largest lenders, I have learned by painful example how major aspects of the GSL program are seriously flawed.

In the brief time allotted, I hope to share with the Subcommittee three things. One, a brief outline of what loan services do and how they get fit into the complex map of the GSL programs; two, a synopsis of what went wrong 2 years ago with the UES loan servicing operation; and three, some ideas and recommendations on how the GSL program can be structurally improved to facilitate better servicing of student loans.

Based on its substantial experience with data processing systems and the servicing of our own NDSL loans, in 1983 UES made a business decision to enter the GSL servicing arena. That was the 1982–83 period.

At the time the Federal Government was strongly encouraging participation in the GSL program by more lenders, secondary markets, and guarantors, in order to assure more access for borrowers. Loan servicers played an important role in this expanded access, because they relieved lenders and secondary markets of the operational tedium of borrower contact and billings. Essentially, a loan servicer does nothing more than send out bills, collect and post loan payments, and contact delinquent borrowers as specified by Federal regulations. Servicers perform ministerial functions. Servicers do not make loans, approve loans, or act as collection agencies for defaulted loans.

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[1] See p. 490 for Mr. Cohen's prepared statement.

As a loan servicer, UES was compensated by lenders and secondary markets on a per loan basis. We did not receive any Federal payments or subsidies, we did not share in any profits made by lenders. Indeed, it is particularly worth noting that it is not in a servicer's best economic interest for a delinquent loan to go into a default since the submission of a default claim by the lender or secondary market results in the loan being removed from the servicer's portfolio, thus terminating the fee basis for that loan and reducing revenues for the servicer.

Individual banks and secondary markets, such as the California Student Loan Finance Corporation, CSLFC, contracted with our loan servicing division, and from 1983 through 1987 our servicing portfolio grew from zero to $600 million. Reflective of the rapid growth of the GSL program, the service center portfolio jumped from $600 million to over $1 billion from the 1987 to 1988 period.

In reality, UES had virtually no control over this rapid increase in volume. The increase reflected the rapid growth in loans made by lenders that were doing business with our servicing center. The increase also reflected the fact that guaranteed student loans were overtaking student grants in the 1980s as the principal mechanism by which students were obliged to fund their post-secondary education.

As volume increased, our existing computer systems proved inadequate to accommodate this rapid growth. In 1987 the service center responded to this problem by installing a new software package on new IBM hardware. The software was intended both to greatly expand loan servicing capacity and to incorporate changes mandated by complex new regulations promulgated by the Department of Education.

These regulations went into considerable detail in specifying a due diligence process that had to be performed on every loan that went delinquent before such a loan could be considered in default and presented to a guarantor for payment. Among other things, this process included specific sequences of phone calls and specific types of letters to student borrowers. The regulations provided no tolerance for error. Sending a letter one day late was sufficient grounds to disqualify a loan for claims payment.

After our new computer system was installed, both UES and its principal customer, CSLFC, detected problems with regard to month-end accounting closings. In February 1988, UES and CSLFC engaged the accounting firm of Peat, Marwick, Main and Co.—now KPMG Peat Marwick—to review the loan servicing systems. As a result of that review and its findings, in March 1988 UES engaged Peat Marwick to modify or rewrite its software programs and systems to correct the known accounting problems.

However, due diligence and regulatory compliance issues surfaced after an on-site review conducted in June 1988 by the Higher Education Assistance Foundation, a national guarantor, and by the early fall of 1988 it became evident that the processing system at our loan servicing center was not able to fully comply with the new Federal due diligence regulations. The nature of the difficulties was further defined when in August 1988 an audit report issued by the U.S. Department of Education called into question the validity of guarantees for approximately half the loans in the service center's $1 billion portfolio on the basis that the due diligence was not adequately documented. By that time UES was aggressively engaged in resolving the difficulties in the loan servicing operation. Management in the loan servicing division was reorganized, and a number of banking and data systems professionals were brought in to take the necessary corrective action.

As a result of these steps, in late August 1988 UES submitted to the Department of Education a complete corrective action plan designed to solve the due diligence problems without any additional cost to taxpayers. However, the Department did not respond to this proposal, and subsequently, in November 1988, UES sold the assets of the servicing center to the Bank of America at a considerable loss and entirely disengaged from the loan servicing business.

Two years have passed since this painful and highly publicized episode. During this time period United Education and Software has paid a very high price for the problems its servicing center faced in meeting the due diligence requirements. The company registered almost $9 million in losses attributable to the loan servicing center alone, and the value of the company stock has dropped from a high of more than $16 per share to a current value of approximately 6 cents per share. Annual revenues have fallen nearly half from their high 2 years ago, and last December the company's principal operating subsidiary was forced by its financial circumstances to file for Chapter 11 protection with the U.S. Bankruptcy Court.

I have engaged in considerable reflection on these events. As a professional quality control engineer I am personally embarrassed. In looking back on what happened, I believe that the problems we experienced with our loan servicing center had two principal causes. First, the loan servicing segment of our business grew too rapidly, in concert with the rapid growth of the program as a whole and the rapid growth of certain lenders' portfolios. This growth was beyond the capacity of the service center and the company's existing computer system to adequately manage.

Second, the new Federal due diligence requirements were extremely complex and were issued with little lead time to allow lenders, secondary markets, and servicers to adapt and adequately test their systems. The new regulations, which left zero tolerance for errors, whether minor or major, were oriented towards specifying the process of servicing student loans rather than seeking to ensure achievement of the goal of minimizing defaults through a diligent servicing process.

If we had it to do all over again, I believe we should have tried to control the exponential growth in servicing business that attended the rapid growth of the GSL program. With 20/20 hindsight, we should have set specific annual limits in the growth of our loan servicing portfolio to allow sufficient opportunity for better staff development and data systems enhancement, as well as to accommodate changes in the regulatory structure, even if that might have meant losing some business.

Having said all that, I also believe that the problems experienced by UES were not unique. The fact of the matter is that the architecture of many student loan servicing systems derives from computer problems originally designed in the private sector for other purposes such as home mortgage and automobile loans. Such loans are collateralized, so if a delinquent borrower fails to pay back a loan, the house or car can be repossessed. But as others have noted, with student loans it is impossible to repossess someone's education.

Student loans therefore are unique, and the due diligence practices for student loans are also unique. Most assuredly, such practices have not been adequately researched or refined. I believe that student loan servicing can best be improved by restructuring and refocusing the current Federal regulations to concentrate more on outcomes rather than process.

More phone calls and more warning letters to delinquent borrowers may look good on paper, but in the real world do they really save the taxpayers money by preventing defaults? This question and others should be independently researched, and with the involvement of expert practitioners in the credit management field.

But as one who has been involved in this arena, let me offer a few suggestions. I believe the current rules should be revised to allow servicers who have made contact with delinquent borrowers to suspend the required sequence of phone calls and letters if there is reason to believe that this will enhance a borrower's willingness to make a payment. We can all attest from experience with computerized credit card billing systems that there is nothing worse than getting a harassing letter a few days after we have sent in a payment check. Unfortunately, current Federal regulations do not permit servicers to exercise any professional judgment in such cases.

I also believe that lenders, servicers, and secondary markets should be required to apply loan refund amounts received from post-secondary institutions to borrowers' accounts within a fixed time period, perhaps 30 days from receipt. Believe it or not, current law requires that colleges and trade schools send refund checks to lenders within a specified time frame, but there is no parallel requirement that the lenders track down who currently owns or services the loan and remit the refund within time frames whatsoever. The loophole in this paper chain may very well result in the Federal Government paying higher default claims than the actual loan balances.

Finally, I believe the GSL program could be, with increased oversight of loan servicers, improved. Perhaps the Department of Education should be authorized to review and approve loan servicers in the same fashion that the Department reviews the administrative capability and performance of loan guarantors. After all, loan servicing is in essence a subcontracting of a key guaranteed student loan function and the Government has every legitimate right to place it under the same sort of umbrella of controls that governs other forms of procurement. Lenders and secondary markets would not be permitted to contract with a servicer lacking such approval. Servicers might also be limited to a specific volume based on their performance record and on their in-place capability.

Senator NUNN. Mr. Cohen, you are saying in effect that UES needed some supervision, right?

Mr. COHEN. No, sir, I am saying that the system should require oversight at every level.

Senator NUNN. Right. But your organization and others like it need some other oversight and supervision, correct?

Mr. COHEN. I think any business engaged in student loans or any Federal funds should have oversight by the agency that is supplying those funds.

Senator NUNN. Including UES?

Mr. COHEN. Including UES, including AFSA, including Sallie Mae, including the guarantee agencies and all the lenders, yes, sir.

In closing, let me echo the sentiments expressed by others who have appeared before this Subcommittee. The American economy of the 21st century will fail to remain competitive with other nations if we do not continue to do everything that we can to provide proper access to post-secondary education for all its citizens. The GSL program serves an essential purpose in providing a broad range of educational opportunity to millions of deserving Americans. In the effort to minimize its cost to the Government, we must not lose sight of its importance in assuring the continuation of that access. Thank you.

Senator NUNN. Thank you.

Mr. Nebeker, we have got a vote on right now and I have got about 6 or 7 minutes before I have to be there. How long approximately would your statement be?

Mr. NEBEKER. I think very abbreviated, Mr. Chairman, based on yesterday's testimony and today.

Senator NUNN. Okay. Why don't you go ahead and then we will take a brief break after your testimony. I will come back and we will have questions for all three of you.

TESTIMONY OF TRENT G. NEBEKER, VICE PRESIDENT, CALIFORNIA STUDENT LOAN FINANCE CORP.

Mr. NEBEKER. I have submitted a full statement.[1]

Senator NUNN. Without objection your full statement will be part of the record.

Mr. NEBEKER. Thank you.

California Student Loan Finance Corporation was incorporated on June 23, 1980 under the nonprofit corporation in the State of California as a nonprofit public benefit corporation exclusively for the purpose of making or acquiring student loans incurred under the Higher Education Act of 1965 as amended.

The corporation established its student loan purchase program in order to provide a secondary market to increase the availability of funds to assist students in obtaining a post-secondary education. Over the past 10 years the corporation entered into student loan purchase agreements with over 40 financial and education institutions which qualify as eligible lenders under the Higher Education Act. To date the corporation has purchased over $2 billion of guaranteed student loans. At July 31, 1990 the corporation held a student loan portfolio totaling approximately $1.1 billion.

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[1] See p. 531.

The funds used to acquire such loans were derived through the issuance of both taxable and tax exempt obligations issued pursuant to 15 discrete trust indentures. The corporation has loan servicing arrangements with AFSA Data Corporation, Costa Mesa Service Center, a subsidiary of AFSA, and Mitchell Sweet & Associates, providing for the servicing of all purchased eligible loans.

As an issuer of tax exempt qualified scholarship funding bonds, the corporation is subject to the plan for doing business requirements of Section 438[d] of the Higher Education Act in order for the corporation to receive special allowance payments from the Secretary of Education.

The corporation's initial plan was approved by the Secretary and subsequent amendments were provided by the Governor of the State of California, as required by the Act. The provisions of the plan are mandated by the Act and including the following elements: [A] No eligible lender in the area served by the authority will be excluded from participation in the program of the authority; [D] The authority will, within the limit of funds available and subject to the applicable State and Federal law, make loans to or purchase loans incurred by all eligible students who are residents of or who attend an eligible institution within the area served by the authority. [E] The authority has a plan under which the authority will pursue the development of a new lender participation in a continuing program of benefits to students, together with the assurances of the existing lender commitments to the program.

From its inception through the end of June 1988, the corporation has succeeded in carrying out its mandate of expanding access of all eligible students to student loans by providing secondary market services to originators of student loans. Until November 1988, a large portion of the corporation's student loan portfolio was serviced by United Education and Software.

The servicing agreement with UES was terminated on November 8, 1988 as a result of the servicing errors resulting in large measure from the failure properly to convert servicing operations from one computer system to another, which resulted in UES' failure to properly perform the due diligence required in the student loan collection.

Servicing of the former UES service portfolio was transferred to Costa Mesa Service Center, again a subsidiary of AFSA Data Corporation.

Prior to the disclosure in June 1988 of the UES servicing breakdown, CSLFC reasonably believed that UES was complying with its collection due diligence duties because of, one, UES hired a new manager of the service center in whom the corporation had faith; two, the corporation was assured by UES that all servicing problems were being resolved; and three, UES was audited by Pete Marwick & Company and others, and such auditors have advised the corporation that UES' due diligence performance was in substantial compliance with the Department's regulations.

The corporations indentures have incurred certain losses due to the insolvency of First Independent Trust Company, a former seller of student loans. The most significant categories of these losses include guarantee fees required to be paid from the indentures due to nonpayment by FIT, which we have discussed earlier in testimony; origination fees required to be paid from the indentures due to nonpayment of FIT—and I would like to point out that these are fees that when you buy the loan you actually pay the lender at that point, this is the second time that we have paid a guarantee fee; cancellations and refunds on loan purchased from FIT for which funds were not returned to the indentures; unreimbursed transfer fees paid on loans purchased from FIT which were subsequently canceled—if we pay them a 1 percent transfer fee, we expect the return of that transfer fee if the loan is canceled or refunded; and improperly originated loans.

Litigation concerning these and other matters is pending between the corporation and FIT. However, it appears imminent that the settlement is forthcoming.

In conclusion, because of the corporation's problems involving UES, FIT, HEAF and others, the corporation is not presently purchasing student loans, as you can well understand. We do look forward to a speedy resolution of these matters so we can continue to provide secondary market services.

Senator Nunn. Thank you very much. We will recess for approximately 10 minutes.

[Brief recess.]

Senator Nunn. The Subcommittee will come to order.

Mr. Cohen, as I understand it, you are the corporate president of United Education and Software, is that right?

Mr. Cohen. Yes, sir.

Senator Nunn. Is that a publicly held corporation or a closely held stock corporation?

Mr. Cohen. If I may explain, United Education and Software, Incorporated is a publicly traded corporation. Its main subsidiary, United Education and Software, is a corporation whose stock is entirely owned by United Education and Software, Incorporated.

Senator Nunn. A wholly owned subsidiary?

Mr. Cohen. Yes.

Senator Nunn. And you are president of both?

Mr. Cohen. No. I resigned as president of United Education and Software, Incorporated and am a director and consultant to that corporation. I am currently, as of this minute, president of United Education and Software, not incorporated.

Senator Nunn. Are you president of the parent corporation or the subsidiary?

Mr. Cohen. The subsidiary.

Senator Nunn. Is it the subsidiary that is involved in loan servicing?

Mr. Cohen. Yes, Mr. Chairman.

Senator Nunn. Who is president of the parent corporation?

Mr. Cohen. Mr. Stanley Schoen.

Senator Nunn. And you were president at one time, is that correct?

Mr. Cohen. Yes, Mr. Chairman.

Senator NUNN. When did that change take place?

Mr. COHEN. About 3 months ago.

Senator NUNN. What exchange is UES listed on?

Mr. COHEN. It is over the counter.

Senator NUNN. Over the counter. What are your responsibilities at UES?

Mr. COHEN. Currently?

Senator NUNN. Well, currently and also back during the 1980s.

Mr. COHEN. Let me take that chronologically. During the 1980s I was president and chief executive officer of both UES and UES, Incorporated, as they were considered one entity. Currently I am the president of UES and my main role and responsibilities as of this date is to work on the reorganization plan for our coming out of Chapter 11, to deal with the liquidation of assets that are going to be required for our reorganization plan in order to come out of Chapter 11, for the coordination of activities needed to develop the plan and identify the liabilities that have to be included in the reorganization plan, and that includes all legal matters and vender liabilities.

Senator NUNN. Does UES run a chain of proprietary schools?

Mr. COHEN. Yes, Mr. Chairman.

Senator NUNN. What type and how many?

Mr. COHEN. We currently own and operate 11 proprietary schools. Two other schools are in a phase-out situation, but when the phase out is completed we will have 11. The type of training we offer is aircraft mechanics, nursing, vocational nursing, welding, machinists, building maintenance, electrical maintenance, those types of trades.

Senator NUNN. Do you have any correspondence schools?

Mr. COHEN. No, sir, not at the present time. We had a correspondence school.

Senator NUNN. It is my understanding that the Higher Education Act prohibits correspondence schools from acting as a lender to its students, is that right?

Mr. COHEN. That is my understanding.

Senator NUNN. Was not UES through FITCO in the 1980s originating loans to the UES-owned correspondence school and other trade schools?

Mr. COHEN. What time period are you referring to?

Senator NUNN. Any time period.

Mr. COHEN. I would have to check the records to see if loans that were originated by FITCO were disbursed to our correspondence school students specifically.

Senator NUNN. But you were originating loans on behalf of FITCO, were you not?

Mr. COHEN. We were doing the application processing, not origination.

Senator NUNN. Not origination. How do you distinguish that?

Mr. COHEN. The application processing involved the collection of the materials necessary for the lender to make the loan and inputting the information into a computer system that then coordinated the loan with the guarantor, which would be an agency like CSAC or HEAF, and would obtain the guarantee verification. Then we would compile that data and give that to the lender, who then issued the check to the student and/or the school, however the case may be.

Senator NUNN. What would an originator have done that you didn't do?

Mr. COHEN. An originator would, as is defined prior to 1986, have also used their funds to fund the——

Senator NUNN. So the word "originator" really applies to funds more than anything else?

Mr. COHEN. Well, it's a complex question and I don't think it can be answered very simply.

Senator NUNN. But you did everything but issue the check?

Mr. COHEN. We did not have the authority to issue the check or approve the loan.

Senator NUNN. I see.

Mr. COHEN. We only did the paperwork.

Senator NUNN. You did the paperwork.

TESTIMONY OF GRETCHEN STAFF, FORMER VICE PRESIDENT, LOAN SERVICING, UNITED EDUCATION AND SOFTWARE

Senator NUNN. Ms. Staff, when did you go to work for UES?

Ms. STAFF. In February 1982.

Senator NUNN. And how long did you work for UES?

Ms. STAFF. Until about the third week of August 1988.

Senator NUNN. And who do you work for now?

Ms. STAFF. I am currently unemployed. I am not employed at this point.

Senator NUNN. Do you live in California?

Ms. STAFF. California.

Senator NUNN. So you worked for UES from 1982 through 1988?

Ms. STAFF. Right.

Senator NUNN. What was your job responsibility there?

Ms. STAFF. Initially I came on board when they were developing some computer systems. They were accounting and administrative software to run the schools. I was brought on board as the general manager in a systems analyst type position.

Senator NUNN. Had you done that kind of work before?

Ms. STAFF. Only in the current—well, I had done it somewhat with the airlines. My previous experience had been with the airlines before I had joined UES.

Senator NUNN. What had you done with the airlines?

Ms. STAFF. I worked in reservations, and actually all the functions within reservations and ticketing, tour desk, dispatching.

Senator NUNN. Did that experience transfer into your new responsibilities at UES? I mean, was it similar responsibilities, or totally different?

Ms. STAFF. They were different.

Senator NUNN. What again were your responsibilities at UES? What was your job description?

Ms. STAFF. Initially I was to oversee the software that was being developed that was then going to be used in the UES schools. At that time they had 6 schools. They were manual, and we were bringing it on board to be an automated situation.

Senator NUNN. Did you do other things during your 5 years or 6 years there?

Ms. STAFF. Yes.

Senator NUNN. What were the other job descriptions?

Ms. STAFF. I also dealt with the fact that UES was selling this software to other schools, and then I dealt with the loan servicing center.

Senator NUNN. With?

Ms. STAFF. The loan servicing center. I went into the loan servicing center in February of 1984.

Senator NUNN. Did you know Mr. Cohen then? Did you report directly to him or did you deal with him in any way?

Ms. STAFF. Yes, obviously I knew Aaron, but I did not report to him until—I reported to another vice president at the time. I think probably end of 1985, maybe 1986 before I actually started reporting directly to Aaron.

Senator NUNN. And you did from 1985 on report to him?

Ms. STAFF. Sometime in 1985 or 1986, I don't remember the exact time.

Senator NUNN. What was your title during this period, 1985–1987?

Ms. STAFF. Somewhere along that time I became a vice president. Prior to that I was considered director.

Senator NUNN. Center director?

Ms. STAFF. No, I was considered the director. The title on a business card would say "Director."

Senator NUNN. What kind of problems did you run into in the 1985–1987 time frame?

Ms. STAFF. We were a rapidly growing division. We worked—the number of loans that we brought in was a very large number and we worked very hard to put an infrastructure in place that would allow us to service these loans at the level that we knew that we should be.

Senator NUNN. Were you overwhelmed?

Ms. STAFF. By 1986 I recognized that we really needed an outside group to give us some guidance. I wanted to hire a consulting group to give us some assistance. We were not overwhelmed in 1986. The magnitude of the number of loans that we were dealing with probably became obvious to us in 1987. We moved our facility at that point.

Senator NUNN. At some point you became really overwhelmed with the volume, didn't you? By this I mean in terms of your ability to handle the volume with an ill-trained staff and insufficient computer capability?

Ms. STAFF. But early 1988 I recognized that. Prior to that I kept thinking if we worked harder and longer hours we could do it.

Senator NUNN. How many people did you have working for you?

Ms. STAFF. It was 190 or so by 1988.

Senator NUNN. Did you make recommendations about how you could handle these problems and try to deal with the backlog?

Ms. STAFF. I did. I had talked about—in the latter part of 1987 we again talked about having a consulting group come on board, and I also talked about by the end of 1987 the fact that I recognized there were more of a backlog in our getting the loans filmed and out of the building again than we could deal with, and I said it would probably take us X period of time for us to get caught up.

Senator NUNN. Do you feel that you had the experience from your previous job to be able to come in and do this job or do you yourself feel that you had not been adequately trained?

Ms. STAFF. Both. Initially I think a lot of it was just high energy determination that I was going to be able to do it.

Senator NUNN. But you didn't really have much background to take on this responsibility did you?

Ms. STAFF. No, I did not. I was not trained in student loans per se.

Senator NUNN. Did UES have a training program for you?

Ms. STAFF. No.

Senator NUNN. Did you have a training program for people that worked under you?

Ms. STAFF. At the individual department levels or units, whether or not it was accounting or whatever, those individual departments had training. It wasn't until 1987 that we really formalized it.

Senator NUNN. Was that at your recommendation?

Ms. STAFF. Yes.

Senator NUNN. Mr. Cohen, in your statement you refer to yourself as a professional quality control engineer, using your words. And one of the prerequisites for that is a trained staff. What was the training program at UES for your employees?

Mr. COHEN. The training program varied from discipline to discipline, and it was left basically to the general manager of the division to develop the training necessary for the employees in that division.

Senator NUNN. Wasn't it a fact that you really didn't have any training program until 1987?

Mr. COHEN. Well, Mr. Chairman, are you referring to the data center or to the corporation?

Senator NUNN. I am referring really to the area of the corporation that handled the student loan servicing.

Mr. COHEN. I would have to defer to Ms. Staff's statement as she was the manager and I would not have been personally involved with that part of the business.

Senator NUNN. As president you didn't feel responsible to make sure you had some adequately trained personnel? That wasn't part of your responsibilities?

Mr. COHEN. It is my responsibility to oversee the operations and to select to the best of my ability people that I felt could do their jobs adequately.

Senator NUNN. Did you think Ms. Staff had been adequately trained, coming from an airline reservationist to running a very substantial student loan operation?

Mr. COHEN. Not initially.

Senator NUNN. What did you do about it?

Mr. COHEN. As you know, our student loan business was an embryo type of situation where we started with zero loans and zero business, and Ms. Staff was involved from the first day in its development and growth, and as it grew she grew with it. And it was our belief at the time that she was doing an adequate job.

Senator NUNN. Looking back on it, should you have had a training program to train people in important positions like Ms. Staff, and others that worked for her? Wouldn't it have made some sense to have some kind of program?

Mr. COHEN. Yes, Mr. Chairman.

Senator NUNN. Was that a mistake?

Mr. COHEN. Yes, Mr. Chairman.

Senator NUNN. Mr. Cohen, as you are, I believe, aware, certain computer programs were discovered at UES which appear to have been designed to insert falsified due diligence entries into borrowers' collection histories. And furthermore, it has been determined by computer experts working on behalf of the Bank of America this these programs were run at least once in 1987. Did you know about any such programs?

Mr. COHEN. I first learned about those programs in early 1989 through correspondence from the Bank of America to our corporate counsel.

Senator NUNN. Before that you didn't know about them?

Mr. COHEN. No, Mr. Chairman.

Senator NUNN. Who was responsible for setting those up?

Mr. COHEN. For setting up the programs?

Senator NUNN. Yes.

Mr. COHEN. The software development was under the responsibility of the general manager of that division.

Senator NUNN. Who was that?

Mr. COHEN. Gretchen Staff.

Senator NUNN. Ms. Staff, did you know there was software that was set up to basically falsify records on due diligence requirements?

Ms. STAFF. No, and I don't believe it was true.

Senator NUNN. So you didn't know about it and you don't think it was true?

Ms. STAFF. That's correct. I have expressed this before to other people.

Senator NUNN. That you don't think it happened?

Ms. STAFF. That's right.

Senator NUNN. So you dispute that?

Ms. STAFF. I do.

Senator NUNN. And you did not know about it yourself?

Ms. STAFF. That's correct.

Senator NUNN. Are you saying that it couldn't have happened without you knowing about it, or could it have happened without you knowing about it? Could somebody working under you have created it without your knowledge?

Ms. STAFF. Sure. We had programming staff there that could have, but there would be no reason. The programming staff wouldn't write arbitrary programs. My only thought that I had expressed previously was that it was part of a testing situation. We had several different automated products in-house, we had many different new ideas new things that came on board all at the same time. It was not unlike the possibility that that could have been set up as some sort of a test program. And I felt very strongly about this.

Senator NUNN. But your testimony——

Ms. **Staff**. It is not something that someone would have done. Particularly I guess—and I noticed in reading some of the comments that the staff have prepared—the type that it was, I mean the type of comments were the type that would come out of a test type situation. They were a redundant type—well, I want to say unsophisticated, low level type of comment, and it didn't seem reasonable, particularly since apparently—I don't remember the names of the people that were involved that showed in the printout—but I think some of the people were not even there any longer.

Senator **Nunn**. Did you ever personally participate in any or know about any falsification of data?

Ms. **Staff**. No. We worked too hard to do things right.

Senator **Nunn**. So if anybody did it, it was without your knowledge?

Ms. **Staff**. That's right.

Senator **Nunn**. Mr. Cohen, did you know of any falsification of data?

Mr. **Cohen**. No, sir.

Senator **Nunn**. If anyone did it, it was without your knowledge?

Mr. **Cohen**. Yes, sir.

Senator **Nunn**. You never directed anyone to falsify data?

Mr. **Cohen**. Absolutely not.

Senator **Nunn**. Mr. Cohen, were you aware of the phenomenal growth in the volumes of loans being serviced by UES as it was happening?

Mr. **Cohen**. Yes, sir.

Senator **Nunn**. What steps did you take to assure that UES would be able to service this volume of loans?

Mr. **Cohen**. We continuously enhanced the software and the hardware required to process the loans. We moved from one facility in Chatsworth to another facility in Santa Ana to another facility in Costa Mesa, each time acquiring more space in anticipation of continuing growth and in order to——

Senator **Nunn**. Looking back on it, what should you have done?

Mr. **Cohen**. As I said in my prepared statement, we should have done it slower, more carefully, not allowed the volume which was presented to us as part of our contract to get away and overwhelm us.

Senator **Nunn**. Ms. Staff, looking back on your experience, what do you believe should have been done?

Ms. **Staff**. Well, the first thing I would have had would have been proper staffing levels, management levels. What I think about now is in terms of what I call an experienced or mature level of management. The proper in-house audit trails and controls, a fully tested automated system that was working before we tried to transfer things over to it. Being able to have enough guts to say hey, we can't take any more business at this time, you are going to have to hold off.

Senator **Nunn**. Mr. Cohen, what role did CSLFC play in decisions about the management of UES?

Mr. **Cohen**. CSLFC was our principal client and they worked hand in hand with Ms. Staff and other parties at the center, which I can only make assumptions there about who they were, but Ms.

Staff mainly, and coordinated their activities with the servicing activities of the center.

Senator **Nunn**. Did they play a role in hiring at UES? Did they tell you who to hire or that you needed additional people?

Mr. **Cohen**. The only role that they had an active participation in, to my knowledge, was in hiring Mr. Richard Lortisch as a consultant to the corporation in 1987 to evaluate the company's ability to take on additional loans in the future in accordance with plans that C3LFC was in the process of developing for future growth. And he was to oversee the operations that we had and to make recommendations on how we could improve it, and also in concert together when we found problems with our accounting in early 1988, end of 1987, that we interviewed and eventually hired Peat Marwick to assist us in correcting the problems in the accounting systems which were caused by the software change in 1987.

Senator **Nunn**. Ms. Staff, did you ever tell anyone, Mr. Cohen or anyone else above you, that you needed to slow down the volume of loans being sent to UES for servicing?

Ms. **Staff**. I had discussed the fact that we needed—that the business was getting to be at such a rapid rate and we really needed to have some feel for when new loans were going to be purchased and then brought in-house.

Senator **Nunn**. Who did you discuss that with?

Ms. **Staff**. With Mr. Nebeker.

Senator **Nunn**. And what was the response from Mr. Nebeker?

Ms. **Staff**. Basically that they really didn't have control over that. It was when a lender would call and say they had a portfolio that they wanted to sell for liquidity purposes, he felt that they needed to respond to that.

Senator **Nunn**. So he basically said that he couldn't control it or wasn't going to control it, right?

Ms. **Staff**. That's correct.

Senator **Nunn**. Did you tell him you were overwhelmed and just couldn't handle it?

Ms. **Staff**. I wouldn't use the word "overwhelmed."

Senator **Nunn**. Well, what did you use?

Ms. **Staff**. Just that we had a large amount of loans that we needed to handle and it was going to be difficult to keep going at the rate we were going.

Senator **Nunn**. Did you have a big backlog then?

Ms. **Staff**. No. We were beginning to see that there were going to be problems. It was a matter of trying to head off potential problems.

Senator **Nunn**. Was anything ever done to slow down this flow?

Ms. **Staff**. Not that I recall.

Senator **Nunn**. Mr. Nebeker, why was that? Do you recall the conversations? Did you realize there was a huge flow and that they basically couldn't handle it?

Mr. **Nebeker**. The huge flow I think was ongoing purchase activity with FIT, and no, I do not recall any of the conversations that Ms. Staff refers to.

Senator **Nunn**. Did you realize that from 1983 to 1988 UES went from servicing approximately $2 million in loans to servicing approximately $1.2 billion in loans? Did you know that?

Mr. **Nebeker**. Yes, I did.

Senator **Nunn**. Did you ever question their ability to handle this kind of load?

Mr. **Nebeker**. Yes, I did.

Senator **Nunn**. What did you do about it?

Mr. **Nebeker**. In 1986 I suggested that UES hire a consultant—the fellow's name is Rich Lortisch—who had extensive student loan experience and banking experience, to review their operation. And additionally, he came in in I think August 1987. It was postponed until August when he was hired by UES to look at that. And at the same time they were putting together their own growth reports and statistics. The other growth factors that are measured are by our—not growth, but in how they are servicing the loans—is by the other audit reports by external parties such as CSAC and our own auditors. Peat Marwick audits were sent out on a yearly basis. And then we sent out, as Mr. Cohen explained, auditors in actually October 1987 from Peat Marwick to look at the financial data side of the system to see that it was operating properly and effectively, and subsequently they were put on board.

Senator **Nunn**. Were you aware, prior to our hearing yesterday, that Mitchell Sweet & Associates, a loan servicer, had been found by the Inspector General's Office of the Department of Education to have falsified records to meet due diligence requirements?

Mr. **Nebeker**. Yes, on a small number of loans.

Senator **Nunn**. When did you know about that?

Mr. **Nebeker**. I don't recall precisely, Mr. Chairman, but it was—I do recall that it was sometime ago in 1988 or 1989.

Senator **Nunn**. Did you continue to use them to service loans after you knew about the fact they had been found to have falsified due diligence requirements?

Mr. **Nebeker**. Mitchell Sweet & Associates? Not to my recollection, no. We ceased all activity.

Senator **Nunn**. You are sure of that?

Mr. **Nebeker**. To my recollection.

Senator **Nunn**. As soon as you found out about their falsification activities, you recall you ceased all activity with them?

Mr. **Nebeker**. That's correct.

Senator **Nunn**. Did you ever encourage any of your service organizations working with you to falsify any data relating to student loans?

Mr. **Nebeker**. Absolutely not.

Senator **Nunn**. Did you ever tolerate such falsification when you found out about it by continuing to conduct business with them?

Mr. **Nebeker**. When I found out about it?

Senator **Nunn**. Yes.

Mr. **Nebeker**. When I found out about it we had terminated UES and discontinued the business with MSA and went about our business in correcting the problem.

Senator **Nunn**. What do you think is wrong with this whole situation, Mr. Nebeker? We asked Mr. Evangelista that. What do you think caused the fiasco?

Mr. **Nebeker**. Well, there are several reasons, Mr. Chairman. One, I agreed with Mr. Kipp's testimony yesterday that somewhat, in my estimation, focused in on the schools and the school programs. Obviously, proprietary schools with the default rates that are being seen today don't fit into an environment like what we are talking about here today.

The second is the due diligence that Mr. Banks talked about yesterday, and the diligence changeover, if you will, from previous years to the March 10, 1987, due diligence requirements, which many student loan experts in the industry will exclaim to be form over substance, which is dot your "i," cross your "t," and if you don't do it you get shot through the head.

But in previous years, from me being a lender in the program for 2 or 3 years, if you had problems with student loans, you would merely contact the Department and the Department would allow you to make up the due diligence in total and sustain no principal or interest loss.

The other change for California Student Loans is from reliance on an external party to monitor servicing through Peat Marwick, through external reports, to directly auditing servicers. Our suggestion to ourselves, which we are taking very honestly, is to get hands-on experience.

Senator **Nunn**. Mr. Richard Fulp testified yesterday, page 15 of his statement, "The loan servicers for the CSLFC portfolio currently include Mitchell Sweet & Associates MSA, and AFSA Data Corporation." Is that wrong?

Mr. **Nebeker**. No, that's correct.

Senator **Nunn**. So you didn't terminate your activities with Mitchell Sweet & Associates?

Mr. **Nebeker**. I thought your question was, Mr. Chairman, did we give them any loans after that. Are you asking me if we terminated the contract?

Senator **Nunn**. Well yes, both.

Mr. **Nebeker**. We terminated allowing loans to be sent over to Mitchell Sweet, but we did not terminate the contract.

Senator **Nunn**. So what are they doing under the contract?

Mr. **Nebeker**. They were servicing the portfolio that was there that was of last December $117 million, which today is now down to approximately $58 million.

Senator **Nunn**. So they continued to service those loans but you didn't give them any new business, is that right?

Mr. **Nebeker**. That's correct.

Senator **Nunn**. Did you tell them it was because they had been found to be falsifying data?

Mr. **Nebeker**. They understood that.

Senator **Nunn**. Did you give them any instructions about the continuing operation, whether they should take corrective action? What did you tell them?

Mr. **Nebeker**. They have been involved in this situation for quite sometime. The Department of Education has actually wished to negotiate the work out of the MSA situation with Bank of America, the lender of record, and not with MSA, and this has been pending for a considerable period of time until the Department finally made judgment or prepared a settlement agreement, to deal with this group of loans that they felt were questionable.

Senator NUNN. Mr. Cohen, what have you done as president of your organization to assure that the schools that you run do bring quality education to the students?

Mr. COHEN. At the schools that we run, we have hired over the past two years senior executives to oversee all phases of the operations. We have brought in experts in financial aid, in Title IV funding to ensure that our students understand their responsibilities and understand their obligations, and also their rights, which oversee all of our programs currently. We have brought in executive directors that are dedicated to providing the best training and best facilities that we can provide for our students.

Senator NUNN. Have you hired certain individuals that worked for the Department of Education to help you straighten out the schools?

Mr. COHEN. Yes, sir.

Senator NUNN. Who are they.

Mr. COHEN. Dr. Ronald Kimberling was with the Department of Education.

Senator NUNN. What was his job with the Department of Education?

Mr. COHEN. I believe it was Assistant Secretary of Education.

Senator NUNN. And he is on your payroll now?

Mr. COHEN. Yes, sir.

Senator NUNN. And who else?

Mr. COHEN. Margaret Orem, also known as Margaret Henry, who was working at the Department.

Senator NUNN. What was her job there?

Mr. COHEN. She was in the policy division and she is now working in our compliance group.

Senator NUNN. Anybody else?

Mr. COHEN. Not that I can recall from the Department of Education in Washington.

Senator NUNN. How about Mr. Arthur Sinai?

Mr. COHEN. Mr. Sinai was brought on for a time period as a consultant to the company to review certain aspects at each school as to their complying with the regulations, and he was to investigate at each facility to make sure everything was okay.

Senator NUNN. What was his former job? Wasn't he with the Department of Education?

Mr. COHEN. I understand he was. I think in fact he was in the IG's Office, investigations, if I remember correctly.

Senator NUNN. Is your company being sued by the State of California now for any kind of problem in terms of your schools? Are you facing a civil lawsuit now?

Mr. COHEN. We have one suit with the Attorney General.

Senator NUNN. What kind of lawsuit is that?

Mr. COHEN. It was a lawsuit directed at our home study school, which has ceased operations.

Senator NUNN. And what are the allegations in that lawsuit?

Mr. COHEN. The allegations were mainly centered about an unresolved audit done by the Department of Education, and essentially that's it.

Senator NUNN. What did the audit show? What are the charges against the school and against your company?

Mr. COHEN. That the course length was not of sufficient length to warrant Federal funds to be used for the program. Late refunds. And essentially those are the two major issues.

Senator NUNN. Is it just one school, or are there other schools involved?

Mr. COHEN. One school.

Senator NUNN. And you terminated operations in that school?

Mr. COHEN. Yes.

Senator NUNN. Why did you decide to do that?

Mr. COHEN. It was a series of events that caused us to do that.

Senator NUNN. Did you terminate before the lawsuit or after the lawsuit?

Mr. COHEN. After the lawsuit.

Senator NUNN. Was the school being run improperly, in your view?

Mr. COHEN. No, it wasn't.

Senator NUNN. What was the reason you terminated operations?

Mr. COHEN. In September, approximately, 1989, the California Student Aid Commission put out a memorandum or a letter, an announcement that the students at that school could not participate in the guaranteed student loan program. The basis of their decision at that time was based on the same audit that I referred to earlier. We went to court, received a temporary restraining order, and won a temporary restraining order, and a month later we won an injunction against CSAC for their actions against the school.

CSAC later sent a letter out to all lenders saying that we could participate and that the prior retraction of approval was canceled. However, those events were such that the lenders, the banks, ceased loaning money to the students that attended that school, and since that school represented 20 to 25 percent of our revenue, it was a major insult to our financial situation, and a month later, since we could no longer receive loans from the lenders in that they did not again start funding the students when CSAC gave them permission to, they continued not to fund those students, we were forced into filing for Chapter 11.

Senator NUNN. Do you have any other schools in that situation?

Mr. COHEN. Any other schools in which situation, sir?

Senator NUNN. In the same situation as that particular school that you have closed.

Mr. COHEN. That we own?

Senator NUNN. Yes.

Mr. COHEN. Because of lack of funds? We have closed many of our schools because of the changes in regulations that have occurred during the past year which did not allow the students to obtain sufficient funding in order to pay their tuition, so we have discontinued operations on many other schools and we are teaching them out.

Senator NUNN. What change in regulation caused that to happen?

Mr. COHEN. In January of this year, the regulation that did not allow non-high school graduates to obtain SLS loans. You have to have a high school diploma to obtain an SLS loan, or if your school had a default rate of over 30 percent, those students at that school could not obtain an SLS loan. We fell under the category only of not having a high school diploma for those students, as the worst default rate we have at any of our schools is less than 15 percent. Our better schools are down around 5 percent. Now, I am referring to the cohort default rate published by the Department of Education 1988. And our cohort rates for our existing schools are, to the best of my knowledge, less than 15 percent in the worst case.

Senator NUNN. That's now, at this time?

Mr. COHEN. Now.

Senator NUNN. What was it in 1987?

Mr. COHEN. Well, each school had its own rate, and they varied according to location and school.

Senator NUNN. What was the highest cohort rate your schools had?

Mr. COHEN. The high, to my recollection, I think we had a school that had 58 percent, and we still have that school.

Senator NUNN. But the default rate has gone down?

Mr. COHEN. Yes, it has gone down substantially.

Senator NUNN. Did you have any others over 30 percent in 1987?

Mr. COHEN. Yes, we did have a few others.

Senator NUNN. What was causing that high default rate?

Mr. COHEN. The default rate is caused by a combination of things; the students you serve, the location of where the school is—well, mainly it is the students you serve, and the location of where the school is.

Senator NUNN. What did you do to get the default rates down? What changes did you make?

Mr. COHEN. Well, we essentially sold or closed those schools that we felt we could do nothing with, and those schools that we could by improving the program of information and training for the students in order to pass their GEDs so that they could better learn their trades, we were able to get our default rates down at several of our schools, and those that we felt we could not we discontinued teaching.

Senator NUNN. The default rate you just cited as having improved, was that 1988 or 1989?

Mr. COHEN. As far as I know there are no 1989 default rates yet available, so it would be 1988.

Senator NUNN. I am informed by staff that the 1988 cohort rate is in error because the Department of Education didn't include $400 million in FITCO loans. Would that affect your good record that you have been talking about?

Mr. COHEN. It might at a few of our schools. I can't speak to that.

Senator NUNN. Did you know there was an error in it?

Mr. COHEN. I understand that there is a calculation problem and that the Department is redoing that at this time.

Senator NUNN. That's going to make your default rate probably look worse, right?

Mr. COHEN. I can't speak to that, sir.

Senator NUNN. You don't know yet?

Mr. COHEN. No.

Senator NUNN. Mr. Evangelista, yesterday the Permanent Subcommittee staff testified that, quoting, "origination fees were taken from a student's loan and deposited in the G.O.F. account" Continuing, "We were also told that Evangelista had moved this account to the Bank of America where it was deposited in an interest bearing account allowing FITCO to collect interest on money that in fact belonged to the Education Department."

Do you agree with that statement?

Mr. **Evangelista**. No.

Senator **Nunn**. That didn't happen?

Mr. **Evangelista**. It happened, but not per your prior explanation.

Senator **Nunn**. Why did it happen?

Mr. **Evangelista**. Well, I think we have to go back and start at the beginning again, Mr. Chairman.

Senator **Nunn**. Let's not go all the way back now.

Mr. **Evangelista**. The first thing that has to be done is that we have got to take a look at we got a trustor who has got a thousand dollars in his account, and this account is going to get a thousand dollar loan. Now, out of that account there is going to be a check written for $940 that goes to the school and to the student. That $60 goes into a trust account that we had earmarked for the purposes of—it was a corporate account that was used to pay off the origination fees and so forth.

Senator **Nunn**. Do you know Theresa Robertson?

Mr. **Evangelista**. Not really.

Senator **Nunn**. Did she work for you? Her name is Theresa Sandoval Robertson.

Mr. **Evangelista**. Oh, yes.

Senator **Nunn**. What were her duties at FITCO?

Mr. **Evangelista**. What was that, sir?

Senator **Nunn**. What were her duties at FITCO?

Mr. **Evangelista**. Well, at the beginning she ran part of the student loan program.

Senator **Nunn**. Why did she leave FITCO, do you know?

Mr. **Evangelista**. She had an argument with some of the employees.

Senator **Nunn**. Do you know what it was about?

Mr. **Evangelista**. That she was being mistreated, I believe.

Senator **Nunn**. She told the staff, quote, that "when capital at the trust company was scarce, FITCO officials withdrew funds from the G.O.F. account and used the money for interest payments to its trust rate clients and for other corporate liabilities." Is this true?

Mr. **Evangelista**. No.

Senator **Nunn**. You are sure?

Mr. **Evangelista**. Yes.

Senator **Nunn**. Mr. Evangelista, what did the term "Deno special" mean? Are you familiar with that term?

Mr. **Evangelista**. Deno special?

Senator **Nunn**. Deno special.

Mr. **Evangelista**. Oh, Deno special. I really can't recall what a Deno special would be. If I get a little more——

Senator **Nunn**. Well, some state banking officials and other regulatory officials, as well former employees of your company, contend that on numerous occasions you made unsecured loans to people from the Common Pool Trust Fund. Is this true?

Mr. **Evangelista**. False, utterly false.

Senator NUNN. You did not make loans to individuals from that fund that were not part of the student loan program?

Mr. EVANGELISTA. The loans were made from trust accounts directed to me by the beneficiaries of the trust.

Senator NUNN. Would you enlarge on that? Tell me what that means.

Mr. EVANGELISTA. Well, once again, you got $2,000 in your trust account, Mr. Chairman. You direct me to one put $1,000 in a student loan, which I will do. You could also direct me to take the other $1,000 and make a loan to someone that you told me.

Senator NUNN. So you always acted upon the instructions of the client who set up the trust?

Mr. EVANGELISTA. That is correct, but they had to give me directions.

Senator NUNN. You never took money that was designated for student loans and loaned it to other individuals outside that program, is that right?

Mr. EVANGELISTA. Positively not.

Senator NUNN. Do you remember making a loan to Mr. Bill Kettle, who owned certain proprietary school chains?

Mr. EVANGELISTA. Probably.

Senator NUNN. You probably remember it or it probably happened?

Mr. EVANGELISTA. There was a loan made to one of his schools.

Senator NUNN. Was that from the funds that were designated under the trust for student loans, or was that from other funds?

Mr. EVANGELISTA. From other funds.

Senator NUNN. What percentage of other funds, non-designated funds, did you have that weren't required to be used in the student loan? Do you know approximately what the percentage would be? Ten percent, five percent, 20, 30, what would it be roughly?

Mr. EVANGELISTA. Well, we had individuals who were completely in stocks and didn't have any student loans at all. We had people who had completely mortgages and maybe a few thousand dollars would be in student loans. Each account would vary, but out of the $67 million we had in trust, that was in the directed trust department side, I would say that probably 60 percent, once again I would guess, was directed to go into student loans.

Senator NUNN. I don't know whether you have seen it but this bank examination basically states President Evangelista said "that the loan had to be made in order to save Bauder College which "blank" owned. Bauder College had filed bankruptcy on November 5, 1981, and subsequently closed. President Evangelista indicated that the closure of the school would have created a heavy work load on the trust company, due to the paperwork which would be involved on the loans that were made to the students in the school. The trust funds in mortgage balance fund HR10 account were apparently used to make the loan in order to protect the trust company and other trust accounts from possible loss or expense."

Are you familiar with that bank report?

Mr. EVANGELISTA. No, I am not, but whatever you read is not true.

Senator NUNN. That is not true?

Mr. EVANGELISTA. No, sir.

Senator Nunn. Here is another examination, 1983 also. This is from Mr. Dennis Kelly, examiner, "The loan to William Kettle detailed on page 24 emphasizes the need for adequate internal controls over fiduciary activities. Management breached its fiduciary responsibility to the beneficiary of the mortgage common trust fund by investing the fund in a loan to a known credit risk at an interest rate substantially below market and with open disregard to standard lending procedures, which resulted in an imperfected and possibly invalid deed of trust."

Are you familiar with that one?

Mr. Evangelista. Well once again, Mr. Chairman, I don't really understand the totality of the question. The question is as to whether or not funds were used to make a loan to any particular individual. If a loan was made to a particular individual from a particular trust, that individual directed me what to do.

Senator Nunn. Which individual directed you what to do, the person who put up the money?

Mr. Evangelista. The person who had the trust.

Senator Nunn. So you never made any loans that breached the trust?

Mr. Evangelista. Absolutely not. We would make a report. If you had a trust with me, Mr. Chairman, and you got a report back and it showed money in student loans and money in Mr. Smith, you would ask me—you certainly would raise a question, what are you doing? You would know that Mr. Smith got the loan because you told me to make the loan to Mr. Smith, and you laid down the conditions.

Senator Nunn. According to state banking records and interviews, often funds were commingled at FITCO. Is this true?

Mr. Evangelista. Commingled with what?

Senator Nunn. Student loan money being put to other uses and back and forth. Was that true?

Mr. Evangelista. Student loan money—first of all, you got to start off that there is a trust, and that trust has assets. Okay. And upon direction those assets would be directed to go into student loans or it would go into any other investment that the beneficiary desired.

Senator Nunn. The 1985 review conducted by the California Banking Department says, "Trust rate deposits are commingled and used to fund student loans, purchase various investments, or deposited in a financial institution. Customers statements only show investments in trust rate." So it basically says there was commingling of funds. I'm just trying to ask you if that was in any way a breach of fiduciary responsibility or is that just standard practice?

Mr. Evangelista. That is standard practice. Trust rate is student loans. There is a trust.

Senator Nunn. If money was in the trust rate account, you didn't take it out to make other loans?

Mr. Evangelista. No. It was a trust rate account, it was an investment in student loans.

There is a misunderstanding here, Mr. Chairman. Trust rate is just something I came up with. Trust rate is an investment in student loans. That portion of the money that went into the student loans received the 91-day Treasury bill rate average for the preceding quarter plus the special allowance that the Government gave. Out of that, by contract we were paid a certain fee above a certain level. So all of the income went to the trust and we charged the fee for being the trustee. Now that is trust rate.

Senator Nunn. Well, the question is did you take other funds and put in there and did you take some of these funds and mix with other funds? Did you make loans to people that were not involved in student loans from the student loan designated money?

Mr. Evangelista. If the trust had a trust rate, it went into student loans.

Senator Nunn. It didn't go to other people?

Mr. Evangelista. No, not unless there was more money that he would direct me to give to some other people.

Senator Nunn. Each trustor, each person setting up the trust, could designate where the money would go?

Mr. Evangelista. That's exactly right.

Senator Nunn. And they could come in and tell you who to make the loan to?

Mr. Evangelista. That's exactly right.

Senator Nunn. And they did on occasion?

Mr. Evangelista. On all occasions.

Senator Nunn. I'm not just saying designated for student loans. They didn't tell you which student to make the loan to, did they?

Mr. Evangelista. No, just make a student loan.

Senator Nunn. Would they come in and tell you to make a loan to Bill Kettle?

Mr. Evangelista. Sure, or anybody else. We had thousands of dollars in loans.

Senator Nunn. That were designated as to an individual?

Mr. Evangelista. To an individual.

Senator Nunn. Now, when you did that, did you follow that order even if there wasn't proper credit and so forth? Did you make the loan based on a normal procedure of checking credit, or did you just go out and make the loan?

Mr. Evangelista. I just followed the instructions of the beneficiary.

Senator Nunn. Even if there was not proper credit, even if the individual was a credit risk?

Mr. Evangelista. That is not an undertaking that we took. If you wanted me to do that, Mr. Chairman, then you would have another fee schedule. Then you are going to be looking for my advice. Then I would do whatever is required to do as a trustee and take whatever action is necessary and do all of the requirements of getting whatever it is. But if you didn't tell me, if it was a directed trust, I just followed your directions.

Senator Nunn. But if it was in the trust rate account it then went only for student loans, is that right?

Mr. Evangelista. Trust rate account is student loans, yes.

Senator Nunn. And you did not make loans to other people that were not part of the student loan program out of the trust rate account?

Mr. Evangelista. No.

Senator **Nunn**. Okay. Were you aware, Mr. Evangelista, that a large amount of loan refunds and cancellations were not being forwarded to the secondary market to be posted against the student's account?

Mr. **Evangelista**. Repeat that question please.

Senator **Nunn**. Were you aware that a large amount of loan refunds and cancellations were not being forwarded to the secondary market to be posted against the student's account? In other words, when you got the money were you aware that in many cases it was not being forwarded on?

Mr. **Evangelista**. Because we were waiting on some action to come about and then we would forward it. Remember that whenever the check got back to us the check would only be for $940 on a $1,000 loan. So there is insurance, and a reconciliation has to be made to get $10 for the insurance and $50 for the origination fee in order to get it back into the account.

Senator **Nunn**. So you are saying you had to wait until everything was complete before you would forward any of it, is that right?

Mr. **Evangelista**. Well, during this period of time I have your trust and a trust has an asset, and asset is a thousand dollar asset, and until the change is made you got a thousand dollar asset, you got a student loan.

Senator **Nunn**. So you don't think you had any obligation to go ahead and forward this money against the loan that had already been sold to the secondary market?

Mr. **Evangelista**. Sure we had the obligation.

Senator **Nunn**. Well, when did you have the obligation? At what point were you supposed to forward the money, in your estimation?

Mr. **Evangelista**. Forward the money to whom?

Senator **Nunn**. To the secondary market, the people who hold the loan, on a refund?

Mr. **Evangelista**. Within a reasonable time.

Senator **Nunn**. What is reasonable?

Mr. **Evangelista**. From 30—30 days.

Senator **Nunn**. In many cases they were held up to 3 years according to records.

Mr. **Evangelista**. Well, they might have—"in many cases," I don't know what "many cases" are, but I would assume that if you do a billion and a half dollars of student loan at a thousand dollars each with split disbursement, a check could be laying off on the side and an error would be made.

Senator **Nunn**. You think it was an error when you held them for 3 years then?

Mr. **Evangelista**. There is an explanation, but we have to get back to the specific loan. If somebody would come up with a specific loan and ask what happened, I think my people would come up with the answer. But just to make a blanket statement that there are checks out there for a particular period of time, I want to know what checks, who to, how did that check come back to us, when that check came back to us did it have a Social Security number, did it have all of the information for us to act?

I called to Jack Keefe's attention many times where we would get checks back from schools that were dated in January and I would get them in May, and I would get checks back with no Social Security number and there was a name "Smith." Now, I had to trace that back so that I could get the proper accounting back to the trust that held that particular note. We weren't using our own money, so there is a tremendous delay, and this is one of the concerns and this is one of the things that we had with the IG report in which the amount of time was allocated in order to do all of the due diligence that we would have to do.

Senator **Nunn**. We are told that during the on-site review that HEAF personnel observed refund checks laying unsecured on a bookshelf next to the outside door. It was estimated there was over $4 million worth of such checks which FITCO had taken no steps to process or forward to the current holders of accounts. Is that wrong?

Mr. **Evangelista**. Wrong. May I explain what is?

Senator **Nunn**. Go ahead.

Mr. **Evangelista**. I would be happy to. When I saw that remark I was wondering what is this all about. Whoever wrote that—and that was from HEAF who made this inspection—is saying that there are checks on top of filing cabinets and so forth. I think I can take you in a lot of banks in which I can show you money on the floor. What she isn't saying is that she was in our vault system. If I wanted to enter, Mr. Chairman, the only way I could enter is, I was the only guy who would kick the door and somebody would come and open it. But she was in the vault. There is nothing irregular or anything involved.

Senator **Nunn**. As of March 31, 1989, I am informed that your own accounting records indicated over $1.2 million of refunds had not been forward to current loan holders. Is that right or wrong?

Mr. **Evangelista**. If the figures show that it is right, and those figures better be right.

Senator **Nunn**. I am told that you had held a number of those for over 3 years.

Well, let's move on to another area. I am told here that in the Theresa Sandoval Robertson's affidavit she states the following, "An additional event that should be brought to the Subcommittee's attention occurred in the 1980s. At that time it came to my attention that student loan checks returned endorsed from a particular school had forged student signatures; signatures that did not match those on the promissory notes we had on file. After students called to complain, I brought this to Evangelista's attention. I was told by Evangelista that the student loan checks from this particular school should continue to be processed until someone from the Department of Education detected the forgeries and told FITCO to stop. Fortunately the Department soon discovered this was happening."

Is that accurate?

Mr. **Evangelista**. Absolutely inaccurate.

Senator **Nunn**. You never told her that?

Mr. **Evangelista**. No, sir.

Senator **Nunn**. And you would remember it if you did?

Mr. **Evangelista**. Most positively I would.

Senator **Nunn**. Did you ever know anything about forged student signatures? Did you ever tolerate that?

Mr. EVANGELISTA. Well, we have been sued by schools for that. We have been sued where our checks were on a school's desk and somebody stole the check and went out and cashed them and we got held liable for it.

Senator NUNN. Mr. Evangelista, do you think it was accurate to advertise trust rate investments as safer than FDIC backed investments, or as backed by the full faith and credit of the U.S. Government?

Mr. EVANGELISTA. A student loan is a full faith and credit obligation of the Government.

Senator NUNN. It is a little bit more complicated than that, isn't it, as what happened in your case pretty well exemplifies? That is rather misleading isn't it? There are all sorts of reasons the Government might not reinsure that loan?

Mr. EVANGELISTA. There could be, yes.

Senator NUNN. Don't you think you had an obligation to tell people a little more fully what the real case was?

Mr. EVANGELISTA. Well, we did. We put out a 4th of July 4 letter that I thought explained a lot of things.

Senator NUNN. Don't you feel bad about misleading a lot of people who have now lost their money?

Mr. EVANGELISTA. I don't believe anybody lost their money.

Senator NUNN. Some investors think so

Mr. EVANGELISTA. I don't know why. If the money isn't in the student loan program, the Banking Department told the court that it balances out, get the money and pay it out.

Senator NUNN. Well, would you admit that saying the full faith and credit of the U.S. Government is behind these loans and that they are safer than the FDIC deposit and so forth, that that is misleading?

Mr. EVANGELISTA. I don't recall that—I recall that incident. I remember one time that somebody said it, and when I looked at it, I wasn't pleased with it, but it wasn't where I was overexcited about it.

Senator NUNN. You didn't think it was quite accurate but it didn't bother you very much?

Mr. EVANGELISTA. Well, it only ran one time.

Senator NUNN. Did you correct it then?

Mr. EVANGELISTA. We stopped it.

Senator NUNN. Was that after the Banking Department told you to stop it?

Mr. EVANGELISTA. I don't recall.

Senator NUNN. Mr. Evangelista, you state that the Banking Department apparently believed what you call, "false and outrageous claims made by certain guarantors against FITCO," and you mentioned CSAC and HEAF by name.

Let me go through a couple of the charges they have made and see if you believe that these are accurate or whether these are false, as you say in your statement.

"In March 1986, CSAC cites FITCO for failure to make timely refunds." Is that false?

Mr. EVANGELISTA. When was that again?

Senator NUNN. March 1986. CSAC cited you, FITCO, for failure to make timely refunds. Was that false?

Mr. **Evangelista**. I wouldn't say it was false and I wouldn't say it would be correct. Once again, what are the loans?

Senator **Nunn**. "From November 1987 to January 1988, CSAC cites FITCO again for failure to make timely refunds and for failure to pay origination fees." Is that false?

Mr. **Evangelista**. No, I believe that would be true.

Senator **Nunn**. "In August 1988 the Department, CSAC, and HEAF cite $600 million in loans originated by FITCO and held by CSLFC as compromised by faulty servicing by UES." Is that true or false?

Mr. **Evangelista**. I don't know.

Senator **Nunn**. You don't know about that?

Mr. **Evangelista**. I don't know whether it is true or false. In terms of the $600,000, or 6 million, whatever that was and the consequences of it.

Senator **Nunn**. "November to December 1988, FITCO files late or fails to file three Forms 799." Is that false?

Mr. **Evangelista**. No.

Senator **Nunn**. That's true?

Mr. **Evangelista**. That's true.

Senator **Nunn**. "February 1989, CSAC again cites FITCO for, among other things, failure to make refunds and failure to pay loan origination fees." Was that citation true or false?

Mr. **Evangelista**. Once again we have to go back to the problems that existed. If there was no reconciliation going on, we would hold it up for reasons that the reconciliation had to be done.

Senator **Nunn**. "In 1989 HEAF conducted a program review of FITCO making the following findings: Number one, failure to safeguard and forward refunds to secondary markets in a timely manner." Was that finding accurate or false?

Mr. **Evangelista**. Whatever HEAF reports as to their findings, I have a lot of questions about their findings.

Senator **Nunn**. "Failure to cancel loans promptly." Is that accurate or inaccurate?

Mr. **Evangelista**. What is "promptly."

Senator **Nunn**. I will let you define it. Is it accurate or inaccurate according to your definition?

Mr. **Evangelista**. It all depends on the loan and the way the loan comes back, Mr. Chairman. We have tremendous difficulties. It has to be understood that—let me put it this way, when we make a loan, we don't expect that loan to come back. We don't expect the loan to be returned to us within 10, 20, 30 days. There is no one in this room who will go to a bank and borrow money and going to borrow this money at 10 percent and when the banker says, how much you want, you say a thousand dollars and you only want it for 10 days, you just talked yourself out of a loan.

So when we make loans we expect those loans to stay out, but because we are dealing with the nature of the schools that exist, those loans do come back rapidly. And lots of things happened when HEAF shut down operation 18 States. When they shut down in 18 States, you have a problem when you are dealing with the number of loans you got, and so it took a lot of work. And the work that had to be done had to be reconciled between HEAF and us.

And we pointed out to them that the reconciliation program was completely out of whack.

So we can't say we have loans unless we look at a particular loan and see what the particular problem was with the particular loan, because if there was no Social Security number on it and we don't know the school, we have to trace that back to the particular trust that owned that loan.

So we are different from a commercial bank. A commercial bank doesn't have to do all of this extra work. And this was one of the problems, Mr. Chairman, that we had with the IG report that constituted where they said that I had to do certain things with these refunds here within 10 days, and still they gave the Chase Manhattan Bank 6 months because they felt that within 6 months that the check would be stale, so there is a dual standard there. So each loan and each activity has to be looked at separately.

Senator NUNN. Mr. Evangelista, would you agree that when you don't process loan refunds and cancellations, that the people who suffer from that in many cases are the students?

Mr. EVANGELISTA. The students will suffer if they ask for another loan.

Senator NUNN. They also will if somebody is out there trying to collect on a loan that has already been refunded, but you never forwarded the money to whoever is holding the loan, won't they?

Mr. EVANGELISTA. That could happen.

Senator NUNN. Isn't that a very bad thing for the student to have given 50 percent of the loan back and then have somebody out there pounding on their door to pay the whole loan back?

Mr. EVANGELISTA. Well, maybe it is so, but I wonder who has got the 5 percent that the student still owns? I must point out that the Government says you will pay the origination fee, and that is being paid by the student.

Senator NUNN. But still the student is basically required to repay a 100 percent of a loan that they really don't owe, correct? If you have not refunded to the holder of the loan the money that has gotten to you, then basically the student is getting hurt, right?

Mr. EVANGELISTA. Well, you have to get back, Mr. Chairman, we have to get the 1 percent back and we have to get the 5 percent so that it comes up to the thousand dollars, because the returned check to me is only for $940. There is work that has to be done before you can send that check back.

Senator NUNN. Let me ask you the same question I asked you to start with. What mistakes do you think you have made looking back on your experience with FITCO?

Mr. EVANGELISTA. My what?

Senator NUNN. Mistakes. What mistakes have you made that contribute to this fiasco?

Mr. EVANGELISTA. It is hard for me to say that we made mistakes in terms other than mistakes that are made by human beings. There is nothing wrong with the philosophy.

Senator NUNN. That's a pretty broad sweep. Well let's just deal with mistakes that are made by human beings then. Which ones of those have you made?

Mr. EVANGELISTA. I don't know of any.

Senator **Nunn**. You don't know of any mistakes? So this is basically all the fault of the people you named to begin with? Bank of America, the banks, State Banking Department?

Mr. **Evangelista**. Well, I am going to have to take——

Senator **Nunn**. Sallie Mae?

Mr. **Evangelista**. We are going to have to take the situation at the particular time.

Senator **Nunn**. Okay. Thank you very much. We appreciate all of you being here.

[Whereupon, at 1:40 p.m., the Subcommittee adjourned subject to the call of the Chair.]

APPENDIX

CONSUMER BANKERS ASSOCIATION *The Association for Retail Banks and Thrift Institutions*
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TESTIMONY OF

WILLIAM L. BANKS

ON BEHALF OF

CONSUMER BANKERS ASSOCIATION

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

September 25, 1990

Mr. Chairman, Members of the Subcommittee on Investigations, my name is William L. Banks, Vice President of Chemical Bank. I am responsible for the product management of Chemical Bank's student loan business and serve as a member of the Education Funding Committee of the Consumer Bankers Association (CBA). I am appearing here today as a representative of CBA, an organization whose membership includes more than 800 banks, thrifts, credit unions and other organizations involved in providing consumer credit. CBA members originate approximately 74 percent of the student loans originated under the Higher Education Act each year.

My testimony today reflects the views of the CBA Education Funding Committee and will focus on six principal areas:

1) the history of the Stafford Student Loan program;
2) the economics of student lending;
3) defaults in the student loan program;
4) guaranty agency solvency; and
5) recommendations to simplify program operations

I. The History of the Student Loan Program.

Congress enacted the Higher Education Act in 1965 as part of the Johnson Administration's Great Society programs. The programs authorized under the Act, including both what is now called the Pell Grant program as well as the student loan programs, were intended to open the doors of higher education to citizens previously excluded for economic reasons.

By all accounts, the programs have been dramatically successful in expanding educational opportunity. Since 1965, the student loan program has provided more than $114 billion in private capital to more than 53 million students. In Fiscal Year 1989 alone, eligible lenders made more than $12.5 billion in insured loans available to 4.7 million borrowers.

In our view, the student loan program is an impressive example of a successful partnership between the federal government and the private sector. Unfortunately, however, that success has been blemished by an increasing level of defaults in the program. In Fiscal Year 1990, the Department of Education expects to pay more than $2.3 billion in defaults. CBA and all other program participants, including guaranty agencies, schools, and students, believe defaults are a problem deserving Congressional attention. In focusing on the default problem, however, it is also important to note that more than 90 percent of all student loans originated are eventually repaid. This, in our view, is an impressive statistic given the fact that student loans are made without a credit test and to students attending a wide variety of eligible educational institutions, as authorized by the Congress.

Since 1965, Congressional oversight and revision of the Guaranteed Student Loan Programs has been constant. For the past eight years, at least one set of amendments has been enacted annually. Since 1965, more than 30 separate amendments affecting the program have been enacted. I will not recount them here, but will note that the original role of the student loan program as a means of providing liquidity to middle-income students and their families has been changed to one of providing basic assistance to low-income families. This evolution in the program, the result of budget pressures, differing political philosophies, and other factors, has resulted in a situation where a growing level of delinquencies and defaults logically follows. The elimination of middle-income students from eligibility for GSL's in the 1986 amendments further concentrated receipt of Federal student aid with low-income borrowers.

The changing profile of the student loan borrower parallels a similar increase in the number of proprietary schools eligible for participation in Federal student financial aid programs. Since 1972, students attending proprietary schools have received aid under the GSL, Pell Grant and several campus-based programs. In 1980, students who had not completed high school but demonstrated an "ability to benefit" from postsecondary education also became eligible to receive Federal assistance.

The 1.5 million students attending 4,000 eligible proprietary schools received 25 percent of all Pell Grant and 6 percent campus-based aid in FY 1988-89. Because the law requires that a Pell Grant not represent more than 50% of attendance costs, in the majority of cases these low-income grant recipients are also GSL borrowers. Because proprietary schools serve a much higher concentration of low-income students than do other sectors of higher education, the increase in the number of students attending proprietary schools results in an increase in the percent of low-income students receiving aid under Title IV programs.

Put another way, since 1981, the administrative task for lenders attempting to collect payments from the borrower has increased. It must also be noted that loans to students at short-term proprietary schools are smaller, go into repayment more quickly and, because of the poorer financial circumstances of these borrowers, are more likely to enter default.[1] Finally, in addition to facing these higher intrinsic servicing costs and a decline in the likelihood of loan repayment, the program has become more complex and, in the view of most lenders, over-regulated.

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[1] Department of Education statistics indicate that the cohort default rate for FY 1987 for proprietary schools was 33%. This contrasts to 7% for four-year public and private schools. The GAO has found that while proprietary school students account for only 22% of the outstanding Title IV loans, they accounted for 44% of the defaults, based on FY 1987 data.

With each amendment (and the subsequent regulations issued by the Department of Education), Federal micromanagement has increased. The regulations governing the program now take up more than 100 pages and are supplemented by a large number of quasi-regulatory "dear colleague letters" and other administrative bulletins by the Department. The current level of detail in the statute and governing regulations would be supported by lenders if it contributed to effective Federal oversight and management. Instead, CBA members believe it puts an unnecessary emphasis on conformity with idiosyncratic procedures rather than efficient loan origination and collection practices. In summary, lenders believe the level of detail in the regulations and the harsh penalties for regulatory violations may actually _divert_ lenders from collecting on loans.

There are now 54 guaranty agencies, 40 secondary markets, and approximately 3,100 active lenders in the Stafford Loan program. More than 8,000 educational institutions also participate in the program. Each of the guaranty agencies is authorized by the Congress to promulgate its own set of program requirements. Many of the secondary markets similarly impose rules or conditions for the purchase of loans that require that the loan program be administered according to specific standards. Lenders attempting to comply with these requirements have found that:

1) Over-regulation has led to a proliferation of rules, standards and administrative requirements which are needlessly complex and create opportunities for inadvertent violations that can jeopardize insurance coverage. Lenders operating state-of-the-art student loan systems have experienced losses in recent years, in spite of every effort to conform to Federal standards.

2) Monitoring and implementing these standards is a difficult task which a small to medium size lender is ill-advised to even attempt. Tracking this constantly changing stream of regulatory and administrative requirements represents a major effort by CBA for its membership. Many regulatory violations, especially by smaller lenders, are caused by ignorance of program rules and regulations.

3) When program changes are enacted, timely guidance must be forthcoming to lenders and other program participants from the Department of Education. Regulations to implement the 1986 amendments to the Higher Education Act, for example, have not yet been released to the community and, by the time these regulations are finalized, the 1991 reauthorization bill could already have

been enacted into law. In a program which we all acknowledge to be extremely complex, where regulatory violations often result in severe financial penalties, NPRMs take on an added significance. I would like to note that the fact that the Department of Education has spent almost five years interpreting Congressional intent from the 1986 reauthorization speaks to the enormity of the task of both implementing and monitoring the Federal student financial aid programs.

In making these comments, we want to be sure there is no misunderstanding. Lenders support diligent program oversight by the Congress and the Department of Education. What CBA members object to are cumbersome requirements which do not contribute to improved collections.

II. Economics of Student Lending

I would like to take a few minutes and share with you in-depth how the evolution of the program has affected the returns lenders are able to achieve through participation.[2] Through this information, I hope to convey to you why many smaller lenders are choosing to restrict or eliminate their participation in the program.

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[2] The GAO is preparing a report of secondary market profitability which is expected to address servicing costs and document the fact that some secondary markets lose money on their participation in the student loan programs.

The principal findings of the CBA analysis which, incidentally, do not take into consideration the effects of Gramm-Rudman sequestration[3] are as follows:

1) Higher default rates result in lower yield on loans. Defaults are always preceded by delinquencies and, when loans are delinquent, lenders must perform the due diligence procedures specified in the regulations or risk loss of insurance coverage. Compliance with these regulations is costly because the regulations include thirteen separate communications with the borrower, both by mail and telephone. In addition, lenders must calculate the cost of occasional non-compliance with the regulations which, however unintended, can result in loss of insurance on the loan.

2) Smaller loans result in lower yield, regardless of delinquency. Because certain basic costs are associated with servicing any loan, regardless of its size, a portfolio consisting of predominantly small account balances has a higher

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[3] Under sequestration, loans are subject to a 40-basis-point reduction in special allowance for the first four quarters of the life of the loan and an increase in loan the origination fee from 5 percent to 5.5 percent. Sequestration is authorized under the Balanced Budget and Emergency Deficit Control Act of 1985, also known as Gramm-Rudman.

per-dollar servicing cost than a portfolio consisting of larger loans. As you may know, the typical proprietary school loan is much smaller than the typical four-year college loan, since proprietary school students tend only to borrow once, whereas a four-year college student loan borrower may borrow repeatedly, thus creating a much larger debt balance.

3) Shorter in-school periods result in lower lender yields. Loans made to students attending short-term courses of study, where the loan enters repayment in the same year in which it was originated, dramatically increase administrative costs per dollar lent. These higher costs make proprietary school loans much less attractive to lenders.

The tables attached to my statement demonstrate these three findings.

III. Defaults

As I noted previously, the issue of defaults has emerged as the single most important student loan issue for the past several years. Not only has this issue arisen because of the cost of defaults, but high default rates have also been an issue in the well-publicized financial problems of the Higher Education

Assistance Foundation (HEAF).[4] Any discussion of defaults must begin with the understanding that, with a program of this nature, a certain level of defaults is inevitable. Guaranteed Student Loans are made only to low-income people with no up-front credit criteria.

During the past four years, Congress has enacted significant default reduction legislation and the Department of Education has issued its default reduction initiative regulations.[5] CBA has cooperated fully in the development and implementation of these needed revisions. The beneficial effects are just now being reflected in default experience under the program and will escalate in the future. Effective collection efforts are as important to students as they are to institutions, guarantors and lenders. Low-income borrowers who successfully complete their education, find satisfying employment and pay off their debts, are enjoying the educational access that student aid programs were meant to provide. Students who drop out of school or fail to find employment, and find themselves burdened by educational debts they are unable to pay, are victims of a well-meaning but ineffective public policy.

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[4] For example, ED reported a 21.1% lender default claim rate and an 18.6% net default rate for HEAF in FY-1988, in contrast to national averages of 13.7% and 10.2% for the two categories, respectively.

[5] These regulations, published as a final regulation on June 5, 1989, placed new requirements on high default rate schools and authorized the initiation of limitation, suspension and termination procedures against high default rate schools. See Federal Register June 5, 1989, pp 24114-24129.

The Congress, in 1986, enacted literally dozens of default reduction measures.[6] I am not going to review all of these measures here. Rather, surveyed lenders indicate that five program modifications implemented since 1986 have been particularly effective in addressing the problem of defaults. These include:

1) Multiple disbursement. This provision requires institutions to make loans available to students in two or more equal payments. Because many defaulters are students who enroll but quickly drop out of school, multiple disbursement reduces by at least 50% the size of the loan they must repay.

2) Institutional eligibility for SLS cut-off based on 30% or higher default rate. Enacted in the 1989 Omnibus Budget Reconciliation Act[7], this measure has drastically reduced proprietary school borrowing under the Supplemental Loan for Students program. SLS loans have higher borrowing limits, do not

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[6] A list of these provisions is attached as an appendix to this statement.

[7] P.L. 101-239. Congress took this action after receiving the GAO Report "Supplemental Student Loans: Who Borrows and Who Defaults," (GAO/HRD-90-33FS, October 17, 1989) and a draft of the Report "Supplemental Student Loans: Who Are the Largest Lenders," (GAO/HRD-90-72FS, February 21, 1990).

require a needs test, and go into immediate repayment. The enactment of this provision quickly eliminated over-use of this loan program by low-income students attending short-term programs.[8]

3) Credit bureau reporting. Lenders, through three separate legislative enactments[9], are required to report student loan information to credit bureaus. The loan must be reported at the time of origination and again when a borrower defaults. Students are notified in advance that this reporting requirement must be met. Both lenders and guarantors believe credit bureau reporting has been effective in reducing defaults.[10]

4) IRS income tax offset. Through an amendment to the tax code, the Federal government can now withhold income tax refunds from delinquent student loan borrowers. As of 1989, in excess of $500 million had been returned to the U.S. Treasury through this provision. Additionally, it is suspected that students formerly

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[8] The reductions in SLS loan volume are documented in "Supplemental Student Loans: Legislative Changes Have Sharply Reduced Loan Volume," (GAO/HRD-90-149FS, August 3, 1990).

[9] These enactments are the Student Financial Assistance Amendments of 1985, enacted in P.L. 99-272, the Higher Education Act Amendments of 1986, P.L. 99-498, and the Higher Education Technical Amendments of 1987, P.L. 100-50.

[10] Lender and guarantor assessments of the effectiveness of credit bureau reporting are summarized in the GAO Report, "Guaranteed Student Loans: Credit Bureau Reporting Practices by Guaranty Agencies and Lenders," GAO/HRD-90-71BR, April 9, 1990.

delinquent, who learned of this provision, voluntarily entered repayment.

5) The Department of Education's Default Reduction Initiative Regulations authorize Limitation, Suspension and Termination procedures against high default rate schools based on institutional default rates. In June of 1989, the Department of Education published a far-reaching regulation aimed at curbing defaults.[11] Among the new requirements were default rate thresholds which, if exceeded, put additional requirements on schools viewed to be problematic or, in the extreme, allowed the Department to initiate limitation, suspension and termination proceedings. Though not absolute cut-offs, these regulations do put schools on notice that default management is a serious concern and one which they share responsibility for with other program participants.

Following the enactment of the 1986 amendments to the Higher Education Act, lenders themselves began examining more closely the default experiences of participating institutions. At a speech before CBA in Washington, D.C. in November, 1988, Charles Kolb, then Deputy Under Secretary at the Department of Education, strongly urged lenders to "police" their schools. This directive was taken to heart. Major banks now limit lending to schools with default rates below 25% and some have cut off lending to proprietary schools entirely.

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[11] See Federal Register, June 5, 1989, pp 24114-24129.

Finally, in the past several years, administration of the program by lenders and guaranty agencies, and by the Department of Education has been tightened. Examples of this improved administration include:

--Use of commissioned salesmen to promote the availability of Supplemental Loans to Students was prohibited; and

--The Secretary was required to make available to institutions and lenders information on debt burdens and total and monthly repayment obligations that students may incur as a result of borrowing under the Stafford program; and

--The Secretary was authorized to terminate lenders engaging in fraudulent or misleading advertising.

CBA believes these actions and other actions taken through statutory change and regulation will directly result in a sharp decrease in defaults. As I mentioned earlier, among the most successful of the actions taken by Congress since 1986 is the elimination of eligibility for Supplemental Loans for Students attending schools with default rates in excess of 30 percent. The General Accounting Office (GAO) recently announced that in the first six months of 1990, borrowing in the SLS program had dropped by approximately 46 percent.[12] More importantly, however, the amendment sent a strong message to schools that the Congress would no longer tolerate schools with high default rates. Many schools, reacting to the message in this amendment, have implemented default reduction plans that will further reduce defaults.

Studies completed to date indicate that students fall behind in payments or default on their loans because of insufficient income to meet their obligations. The most common profile of a student loan defaulter is a low-income borrower who left school without receiving a degree or certificate. These students are individuals who, instead of profiting from higher education, find themselves in worse financial circumstances for having received a student loan. The Stafford Student Loan program, as it now operates, makes loans available to students and requires that they repay them, even if they never finish school. In CBA's view, a major part of default reduction must be directed at reducing negative educational outcomes, including students dropping out without completing a chosen course of study or students unable to find employment in career fields for which they have become certified.

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[12] Based on the GAOs study of the volume of 10 guaranty agencies, as reported in the GAO report, "Supplemental Student Loans: Legislative Changes Have Sharply Reduced Loan Volume," GAO/HRD-90-149FS, p 2.

Members of the Senate and House are now in Conference on S. 695, the "President's Excellence in Education" Act. The Senate version of this legislation contains additional measures to reduce student loan defaults. Senator Claiborne Pell (D-RI), Chairman of the Senate Subcommittee on Education, Arts and Humanities is to be commended for this legislation and for his continuing persistence in bringing default reduction initiatives before the Congress.

Title VI of S. 695 contains student loan program modifications which will address several program areas that remain troublesome. CBA endorses all the amendments contained in that legislation, most particularly those aimed at strengthening ties between guaranty agencies and state licensing boards and prohibitions on so-called "accreditation jumping" by unscrupulous educational institutions.

IV. Problems with the Current Due Diligence Regulations

I would now like to turn to lender concerns with the regulations governing lender servicing of loans made in the GSL programs.

CBA has supported Congressional and Department of Education efforts to reduce defaults, but believes that some such efforts have gone too far. The most dramatic example are the servicing requirements for delinquent loans. In November of 1986, Congress issued new requirements for servicing loans.[13] These regulations, which became effective on March 10, 1987, have proven difficult to comply with for even the most conscientious lenders in the program. As I have noted earlier, the regulations call for the performance of thirteen separate contacts with the debtor, generally timed within thirty day "buckets" of time. A delay in performing one of these steps by more than five days results in a significant interest penalty. The minimum interest penalty corresponds to roughly ninety days, the average period of time for the lender to prepare the claim and submit it to the guaranty agency for payment. A more egregious violation, such as the missing of three steps or a gap between collection efforts of 46 or more days, results in loss of principal and interest. These penalties are disproportionate to the "crime" of the lender failing to perform servicing strictly in accordance with these regulations.

There are currently over $55 billion in student loans outstanding. The 1987 due diligence regulations, and all other changes in the law enacted by the Congress, apply both prospectively and retrospectively. In other words, the rules often change in the middle of the game. These changes, though at times necessary, are confusing to students, costly to lenders, servicers, and guaranty agencies, and are often difficult to implement in the time frames provided. A fair examination of how well various participants manage their student loan programs must take this issue of a constantly changing regulatory environment into account.

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[13] The servicing regulations are found at 34 C.F.R. 682.411 and were published on November 10, 1986, Federal Register pp 40886-40947.

CBA understands that the Department of Education at least partially agrees with its concerns regarding the due diligence regulations.[14] The Department expects to publish in the next few weeks new regulations which will substantially restructure the requirements of due diligence. CBA is hopeful that these new regulations will address many of the concerns lenders have voiced regarding the current requirements.

V. Problems at HEAF

The recent financial problems at HEAF are another area of major concern to lenders participating in the program. CBA is pleased that Secretary Cavazos is expected to announce a resolution to this problem that is in the best interests of both the Federal government and the students served by the program.

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[14] Based on presentations on the new regulations made by Department of Education officials at lender and guarantor trade association meetings.

It is worth noting that, for the past several years, CBA has requested that Congress enact legislation requiring the Secretary to specify steps to be taken to address financial problems of an insolvent guaranty agency. This proposal has not been acted on. The situation at HEAF has further intensified CBA's concern regarding this issue and our belief that procedures should be enacted by the Congress to give the Department procedural guidance in the event of future guaranty agency insolvencies. CBA continues to believe that the Federal government should provide full faith and credit behind guaranty agency insurance commitments. Only through this step will lender confidence, severely shaken by the HEAF crisis, be restored.

Though the immediate crisis at HEAF will soon be resolved, the uncertainties raised by this problem continue to be felt in the student loan marketplace. Every lender managing a significant student loan portfolio has had reason to review and re-evaluate its current financial exposure and continued participation in these programs. CBA believes Congress needs to address this problem in the next reauthorization.

VI. Recommendations for Change

I will not review all of the recommendations for changes to the Higher Education Act that CBA anticipates pursuing in the reauthorization process.[15] Instead, I would like to focus on a single area--program simplification.

Program simplification represents an opportunity to reduce the cost of the program while, at the same time, making it work more effectively for the intended beneficiaries--students at postsecondary institutions. In addition to addressing the problem of guaranty agency solvency and the complexity of the servicing requirements, CBA has also recommended that Congress consider the following modifications:

1) Deferment simplification. There are presently fifteen separate deferment categories available to borrowers, including one for active duty members of the National Oceanographic and Atmospheric Administration. Regardless of how few individuals this deferment applies to, every student loan recipient must be given written and oral explanations of this deferment status.

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[15] CBA's reauthorization recommendations are included in the CBA 1991 Student Loan Reauthorization Guide, published by CBA, 1990.

CBA recommends all deferments be repealed and replaced with two deferments: one for in-school status and the other for financial hardship.

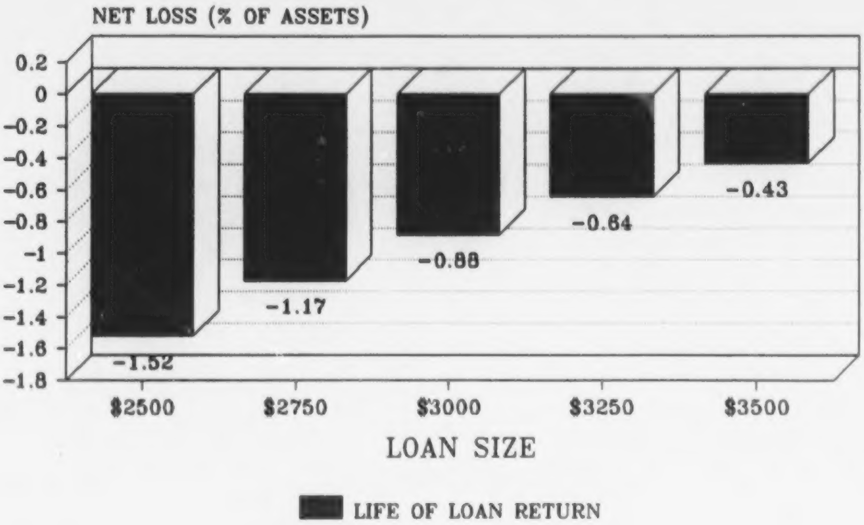
2) Form and requirement consistency between agencies. Each of the guaranty agencies in the program has promulgated its own set of rules, regulations, forms, and procedures. The differences between agencies is frequently meaningless--as if the individual agencies purposely sought to establish a policy for the sake of being different. CBA believes Congress should explore means of discouraging unnecessary differences and actively promoting uniformity in forms, procedures and other program requirements.

In closing, CBA would like to emphasize that, notwithstanding the well-publicized problems facing the program, we believe the Stafford Student Loan Program is fundamentally sound. We support efforts to date by the Department and the Congress to improve loan collections while at the same time protecting the rights of student borrowers. CBA believes that morals and ethics play an important role in the student loan program and we categorically oppose fraudulent practices which take advantage of student borrowers and abuse the public trust. Hopefully, the Congress, the Administration, and others can work together in reauthorization to address the default problem more completely, close opportunities for fraud and abuse, and make the program work more efficiently for students.

Thank you for the opportunity to testify here today. I would be happy to respond to any questions you may have.

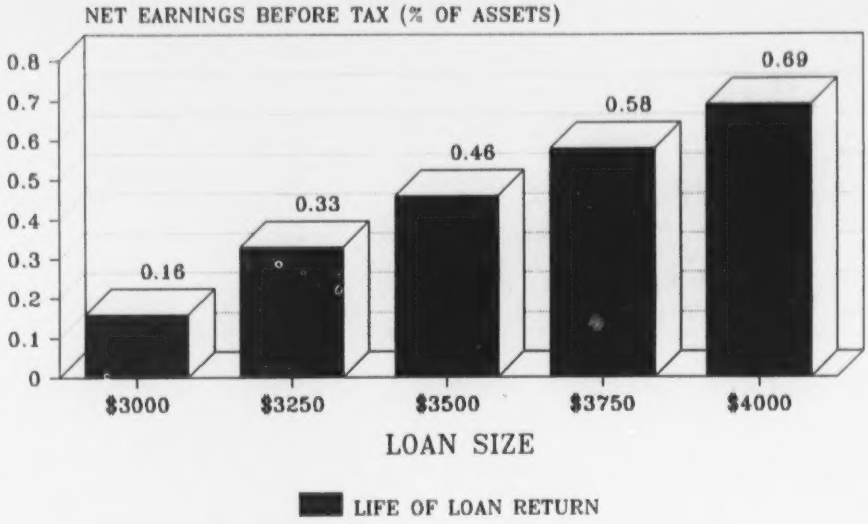
(105A400.1)

STUDENT LOANS FOR PROPRIETARY SCHOOL
NET LOSS BEFORE TAX VS. LOAN SIZE
50% DEFAULT RATE



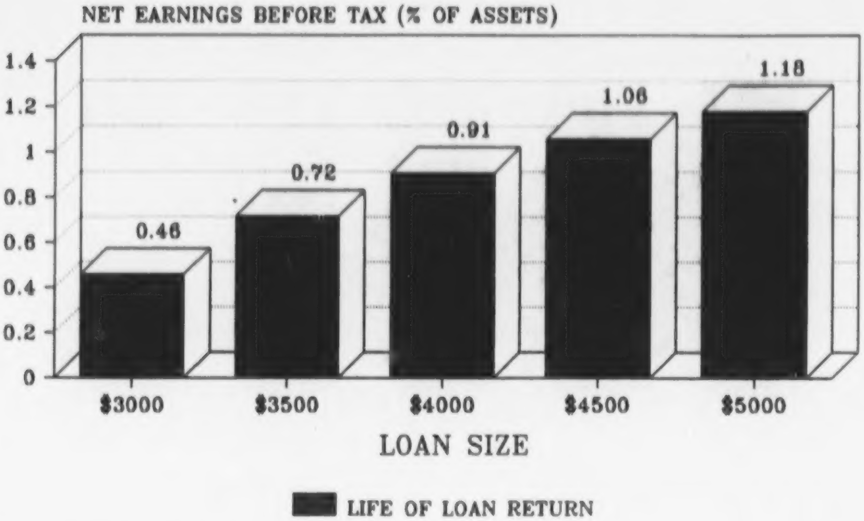
12 MONTH IN-SCHOOL; 72 MONTH REPAY

STUDENT LOANS FOR COMMUNITY COLLEGE
NET EARNINGS BEFORE TAX VS. LOAN SIZE
20% DEFAULT RATE



24 MONTH IN-SCHOOL; 72 MONTH REPAY

STUDENT LOANS FOR FOUR YEAR COLLEGE
NET EARNINGS BEFORE TAX VS. LOAN SIZE
10% DEFAULT RATE



36 MONTH IN-SCHOOL; 72 MONTH REPAY

Summary of Default Reduction Provisions Enacted in the Higher Education Amendments of 1986 (P.L. 99-498)

- Reaffirms mandated multiple disbursement of loans.
- Prohibits loan agencies from offering inducements to education institutions or employees to secure applications for loans.
- Allows any guaranty agency to request information from any other agency on borrowing by students in its State.
- Establishes a reinsurance fee based on default rates to be paid to the federal government by guaranty agencies; agencies with a default rate less than 5% will pay a fee equal to .25% of the total principal amount of loans on which they issued insurance during the fiscal year and agencies with rates equal to or greater than 5% will pay a fee equal to .5% of such amount.
- Requires guaranty agencies to submit proof that reasonable attempts were made to locate the borrower, in the case of a defaulted loan when the borrower's location was unknown, and proof of contact with the borrower when the location was known.
- Allows guaranty agencies to permit forbearance on defaulted loans.
- Allows disposable pay to be garnished up to 10% if adopted by the State. Requires notice to the borrower and an opportunity to respond; provides the borrower with an opportunity to review existing information; provides the borrower the opportunity to establish a repayment schedule with the guaranty agency; sets penalties for employers' non-compliance after notice; and prohibits the employer from firing or taking disciplinary action against an employee whose wages are garnished.
- On a three-year pilot project basis, allows guaranty agencies or the Secretary to sell defaulted loans which have been in repayment status for 12 months and allows the borrower having such a rehabilitated loan to be eligible to receive additional loans.
- Allows guaranty agencies to provide information to eligible institutions on former students of the institution who are in default, including the names and addresses of such students. Public dissemination of such information is not authorized. Activities performed by educational institutions relating to delinquent or defaulted borrowers must be clearly supplemental to the due diligence required to be performed by guarantors and lenders.
- Provides for graduated or income-sensitive repayment in the case of consolidated loans.
- Requires guaranty agencies and lenders to submit proof that attempts were made to locate the borrower in the case of consolidated loans.
- Requires guaranty agencies and lenders, as appropriate, to make reports to credit bureaus on current balances, default date, and collection and cancellation of the loan through repayment. Holders of loans are to report on loans in good

standing and guaranty agencies on loans in default status.

- Requires the Secretary to limit, suspend, or terminate lenders who engage in fraudulent or misleading advertising that may have led to making loans or the making of loans that violate the certification of eligibility.
- Authorizes the Secretary to sell defaulted loans (assigned to the United States) to collection agencies, lenders, or other parties if those loans are in default status and only as a last recourse after all other collection agencies, lenders, or other parties if those loans are in default status and only as a last recourse after all other collection efforts have failed and the loan has been in default for at least one year.
- Requires that lenders inform student borrowers of the total cumulative balance owed, the projected level of indebtedness of the student based on a four-year college career and an estimate of the projected monthly repayment for those loans held by the lender.
- Requires the lender, each time a loan is disbursed, to provide the borrower with a separate paper summarizing his rights and responsibilities in plain English, including a statement of consequences of default and a statement that defaults will be reported to a credit bureau.
- Prohibits the use of commissioned salesmen to promote the availability of supplemental loans.
- Prohibits unsolicited mailings of student loan application forms to students unless students have previously received loans from that lender.
- Prohibits students who are in default under the Stafford or Perkins programs or owing any refund on any federal grant program, from receiving any form of federal assistance while they remain in default.
- Required exit counseling of student loan borrowers which provides general information on the average indebtedness of students, the average anticipated monthly repayments and the available repayment options. Such counseling can be provided to either individuals or groups of students.
- Requires the Secretary to make available to institutions and lenders information on debt burdens and total and monthly repayment obligations that students may incur as a result of borrowing under the Stafford programs.
- Creates a National Student Loan Data System which will maintain computerized student loan data on Stafford and Perkins programs.

(105A419)

Hearing Follow-Up Questions

William L. Banks
Vice President, Student Loan Division
Chemical Bank
Representing Consumer Bankers Association

Q. Does the CBA have an opinion as to whether proprietary schools in general should continue participation in this program?

A. CBA believes that participation of proprietary schools in the student loan programs is appropriate. We note that the Omnibus Budget Reconciliation Bill of 1990 imposes restrictions on institutional participation (35% default rate cut off in FY 1991), thereby eliminating most problem schools from the program. The approach incorporated in reconciliation--termination on the basis of default rate--is fairer to schools than a restriction based on control or corporate structure.

Q. Schools which experience high cancellation or refund rate can be troublesome and costly to lenders. What ballpark cancellation rate should lenders use before they decide not to do student loan business with a school's students?

A. Default rate is the most significant indicator of administration or educational problems at a school and has been appropriately utilized in the student loan program restrictions enacted in the Omnibus Budget Reconciliation Act of 1990. However, there is also a correlation between cancellation and high defaults. CBA recommends that research be done to determine what cancellation rate might be utilized to establish an additional restriction on institutional participation based on cancellation rate. CBA believes that, on the basis of currently available information, default rate, rather than cancellation rate, should be utilized as the basis for any limitation on institutional participation.

Q. Do your lender members experience wide variations by the Department of Education and guarantee agencies within the scope of program reviews or subsequent enforcement of regulations?

A. The recent Department of Education requirement that guarantors monitor their top lenders on an biennial basis has created additional audits for lenders dealing in multiple states. The majority of guarantor auditors are knowledgeable and aggressive. Audit sampling techniques are fairly consistent between agencies. Inconsistencies exist, however, on how various guaranty agencies interpret federal regulations. Differences in regulatory interpretations create an administrative burden for lenders.

Department of Education audits deal primarily with the Form 799 (billing for interest and special allowance payments). Separately, The Department of Education's Office of Inspector General contracted with the Accounting Firm of Price Waterhouse to audit various phases of large lender's operations. The accountants from Price Waterhouse, who audited Chemical Bank, were professional, knowledgeable, and utilized sampling techniques similar to those we have experienced with guarantor auditors.

Q. Should participating lenders be subject to independent compliance audits by CPA firms?

A. Many large lenders and servicers believe an independent audit would be desirable if it could replace the work necessary to support each state guarantee agency's team on separate audits. The expense may be prohibitive for a small lender in the program.

Q. Should credit checks on student loan borrowers be required to see if they have filed for bankruptcy, defaulted on other loans, or have other adverse credit information previously?

A. Chemical Bank does credit checks on Parent Loan borrowers for items described in your questions. Performing such credit checks on student borrowers would be very expensive with only a minimal number of borrowers actually showing a credit history. The returns to the government would be small compared to the expense to the lender community.

(105A480)

STAFF STATEMENT

HEARINGS ON

ABUSES IN FEDERAL STUDENT AID PROGRAMS: LENDERS, GUARANTEE AGENCIES, LOAN SERVICERS AND THE SECONDARY MARKET

SEPTEMBER 25, 1990

* * *

Mr. Chairman and Members of the Subcommittee, as the Subcommittee's investigation into fraud and abuse in the Federal student aid programs continues into the roles of other program participants, we, unfortunately, do not bring good news. Fraud, waste, and abuse are not only being committed by loan and grant recipients and the schools they attend, but by some banks and loan servicing operators as well. The victims - taxpayers and Americans trying to better themselves - remain the same.

In previous hearings on this subject, the staff has testified regarding the extent of fraud, waste, and abuse involving school owners and employees, and have been critical of the alarmingly weak federal, state, and private sector oversight processes that are supposed to safeguard students and taxpayers.

Mr. Chairman, the staff wants to emphasize that this is an investigation of fraud, waste and abuse in this federal program. The thousands of people who work honestly and effectively should not go unnoticed. But, as you well know, it takes only a few well placed people to turn any program into a disaster. The Pentagon Ill Wind investigation of contracting, the conflicts, fraud and abuse in HUD's programs and more recently the Savings and Loan debacle all sadly show how easily programs can be abused and how ineffective oversight can be pre-empted.

Today we turn our focus to the financial players in the student loan industry: lenders, guarantee agencies, loan servicers, and the student loan secondary markets. Our investigation has confirmed that there are enough financial institution and servicer participants taking shortcuts, misrepresenting themselves, and engaging in fraud and abuse to cheat the taxpayer out of hundreds of millions of dollars and seriously threaten the reputation and future stability of these programs. These abuses, combined with the legitimate and recognized payments involved in this program, have fueled a rise in costs far beyond any reasonable expectation.

Further, as with other parts of the program that we have examined, in this area we found that fraud and program abuse has historically not received the level of attention it should have by the Department of Education. The Department of Education is at best, a very poor enforcer of federal law and regulation over program participants. Students continue to be at the mercy of a seemingly uncaring, and often unresponsive, massive bureaucracy of federal program offices, huge banks, guarantee agencies, and their loan servicing center computers.

PROGRAM SIZE

The guaranteed student loan programs have grown at an amazing rate in the past decade. Increasing education costs, a shift away from federal educational grants, and the ever increasing number of trade school students are among the factors which account for this growth.

For all federal guaranteed student loan programs, during fiscal year 1989, the government committed itself to 4,714,000 student loans, representing $12,464,000,000 of guaranteed principal. Since the inception of the guaranteed student loan program in 1966, through September 30, 1989, the government has committed to guarantee $101,675,000,000 in principal. Of that amount, $74,029,160,000 has matured and $10,457,646,000 has been paid to lenders in default claims, or 14.1% of the matured loan amount has been reimbursed to lenders in default. Over the years, the government and guarantee agencies have been successful in collecting $3,331,511,000 of those defaulted loans.

Last week the General Accounting Office testified before the Full Committee regarding the government's guaranteed loan programs. GAO has experienced major problems in their attempts to audit the guaranteed student loan insurance fund. GAO reported that:

> "...the Guaranteed Student Loan Insurance Fund's enabling legislation (20 U.S.C. 1082 (b) (2)) requires us to annually audit the fund's financial statements. We have found, however, that the fund's financial statements have been unauditable. Our last audit, which covered the fund's fiscal year 1980 financial statements, resulted in an adverse opinion because of the serious accounting and reporting problems we encountered. A more recent attempt to audit the fund's financial statements--those for fiscal year 1985--was terminated because of the poor condition of the financial records. More currently, in a January 23, 1990, letter to the Committee (GAO/OCG-90-1), we identified Education's guaranteed student loan program as a "high risk" area vulnerable to loss and have begun a financial statement audit of the fund. We have not yet determined whether the fund's fiscal year 1990 financial statements will be suitable or data with respect to loan guarantees is accurate."
>
> "We have also reported that the government's overall loan picture is worse than reported by agencies and that the government needs reliable financial

> information on credit programs, which would encompass guaranteed loan programs. To strengthen financial reporting for these programs, we recommended that the Congress require agencies to provide it with audited financial information on their receivables and delinquencies. OMB agreed with our recommendation and has expressed its intention to take concrete steps toward annual audited financial statements of the major credit programs."

No matter what changes are made to the student loan programs in the future, we are, unfortunately, stuck with past mistakes and remain committed to the loans already guaranteed.

THE PLAYERS: LENDERS

Lenders (banks, savings and loans, credit unions, trust companies, pension funds, insurance companies, State agencies, some schools, guarantee agencies and secondary markets) make loans to, or hold the loans of eligible students.

Eligible lenders are defined in the Higher Education Act of 1965, section 435, (20 USC 1085). A copy of that section pertaining to lenders is attached to this statement as appendix A. These critical definitions will be explored later in this statement, but please note that the definitions do not require the lender to participate in either state or federal bank insurance programs.

By and large, students apply to lenders for loans through a school's student financial aid office. The school has already entered into an agreement with a guarantee agency, and the school uses lenders supplied by that guarantee agency. Those lenders have also entered into written agreements with the guarantee agency.

Lenders deduct from the principal borrowed an insurance fee to be paid to the guarantee agency. The insurance fee paid varies among the guarantee agencies, but may not be higher than 3% of the loan principal. For Stafford Loans, in addition to the guarantee fee, the student borrower also pays a five percent origination fee to the Department of Education. The origination and guarantee fees are deducted from the loan principal by lender. The originating lender may hold the loan throughout the life of the loan, or sell it to another eligible lender, commonly referred to as the secondary market, at any time.

When the guarantor and lender enter into that written agreement, the lender is issued a lender identification number.

The lender identification number is used by the lender, guarantee agency, and the Department of Education to track loan volume, collect insurance premiums and origination fees from the lender, and to pay special allowance and interest subsidies to the holder of the loan. Because a lender may participate in the program through several guarantee agencies, one lender may have multiple lender identification numbers for program participati

The Department advised us that there are 29,384 lender identification numbers that are valid, but only 17,573 that are participating at this time. Of those, 13,179 lender numbers are eligible to collect special allowance and interest. That number of accounts collected $2,618,000,000 in special allowance and interest last year from the federal government.

While the student is in school, the federal government pays to the holder of the loan note interest and special allowance. The special allowance, currently 3.25% above the 91 day Treasury bill, which is designed as an incentive to keep lenders in the program, is the moneymaker for loan holders. In addition to the insurance premium paid by the borrower, guarantee agencies receive an Administrative Cost Allowance (one percent of the guaranteed loan volume) from the Department of Education for their trouble, so factual reporting by the agency is also important.

Lenders report their loan originations and loans on hand on a quarterly basis via a departmental form (ED form 799). The Department has no way of knowing, short of an on-site program review at the lender's offices, whether or not the lender is filing the required form. This is a very serious issue. In March 1988, a Department of Education program review at the Bank of Horton, Kansas, the nations third leading originator of student loans, determined that the bank had not filed its forms 799, for 1 1/2 years. As a result, the Department did not know of at least $259,622,185 in originated loans and, even more outrageous, the Bank of Horton had not forwarded about $4.4 million in origination fees due on those loans to the Department. These fees are deducted from the principal borrowed - the student pays the fee. Under the regulations, the Department of Education may choose not to reinsure claims paid on loans if the lender fails to forward to the Department the 5% origination fee on Stafford loans. Guarantee agencies will not pay guarantee claims if the insurance premium has not been paid to the guarantor.

In the Bank of Horton case, however, the Department allowed the bank to simply pay the bill without penalty, even though the bank had collected interest on the money while the system slept.

In our case study of FITCO, we will see that the Bank of Horton was not alone in this practice. Mr. Chairman, I offer as an exhibit, a copy of Department of Education Inspector General Management Improvement Report No. 90-10, which explores this problem.

A list of 1988 and 1989 "top 100" originating lenders is attached to this statement as appendix B.

Mr. Chairman, the Resolution Trust Corporation advised us that there are seventy one savings and loan institutions in either conservatorship or receivership with combined student loan portfolios of $192,049,000. Some of these portfolios have not been properly serviced, slowing the already difficult task the RTC has in supervising these troubled thrifts. I offer as an exhibit, a listing of these institutions.

GUARANTEE AGENCIES

The loans are guaranteed, for a fee charged to the borrower, by one of the state or non-profit guarantee agencies. A list of the current guarantee agencies are attached to this statement as appendix C.

These agencies were created to act as the middleman for the federal government in the loan program. At that time, we were told, there was insufficient lender participation in the program. In the early 1980's financial incentives were built in to encourage more lender participation. It appears that these incentives may have been too lucrative in the early days, creating an atmosphere ripe for abuse. Initial loan volume often equalled fast and easy profit for guarantee agencies. In 1986, however, the regulations changed, requiring detailed collection steps not previously conducted.

DUE DILIGENCE: THAT LOAN MAY NOT BE GUARANTEED

Prior to 1987, lenders and guarantors had to use at least the same diligence in collecting a student loan as they exercised for their other commercial loans. Default claims were processed quickly by guarantee agencies and the government paid the reinsurance on the claim with little concern. Increasing concern over default costs ended this scenario, and the Department instituted specific due diligence requirements on the collection of delinquent and defaulted loans. Guarantee agencies started rejecting claims from lenders.

Lenders were also supposed to exercise the same due diligence in the making of a student loan as they would if the loan was not guaranteed. In the 1980s, this requirement was ignored by some originating lenders.

The guarantee on loans in the program is conditional. If lenders fail to exercise the required diligence, guarantor and/or the the Department may withdraw the guarantee on the loan and not pay the lender's claim. The current requirements for collection activity are depicted on a chart attached as appendix D. The chart was provided to the staff by the Student Loan Marketing Association. These due diligence steps consists of a series of telephone calls and letters to delinquent borrowers. These steps must be taken in the allotted time, or the loan looses its federal guarantee. The lender may, however, "cure" the servicing violation and restore the loan's guarantee.

Despite the possible loss of the federal guarantee, there is evidence suggesting that many lenders fail to comply with due diligence requirements. The Inspector General has also conducted an audit of guarantee agency reviews of lenders. In another Management Improvement Report, No. 90-9, which I offer as an exhibit, the IG discussed that many participating lenders have been cited for serious, and continuing due-diligence compliance violations. The IG found that 87 percent of the borrower files reviewed at 101 lenders contained due-diligence exceptions. Eighty percent of the exceptions involved repayment and collection problems. The IG found that the Department of Education merely reviews the guarantee agency lender review reports to determine if a site review guide was used, the scope of the review, and if the findings and recommendations were appropriate. The Department deals with the guarantee agency, not the lender, for any follow-up. The IG report calls for immediate corrective action:

> "Although the revised due diligence regulations have been in effect for 3 years, lender reviews show a high level of noncompliance. The total Stafford loan volume for fiscal year 1988 was 4.5 million loans, representing about $11.8 billion in loan commitments. Because of the high rate of exceptions noted in our analysis, 87 percent (33 percent if the exceptions at the single largest lender are excluded), we believe the Department should use stronger measures to ensure that lenders improve the management of their loan portfolios. Since the agencies' lender review reports that did identify reasons for noncompliance cited problems with EDP controls and lack of adequately trained personnel, we believe that immediate improvements in these areas are essential."

PROBLEMS IN THE SYSTEM:
GUARANTEE AGENCY TROUBLES

Our investigation found that skyrocketing loan volume and default rates coupled with growing problems of waste, fraud, and abuse have begun to adversely affect the continued financial stability of some guarantee agencies.

After reimbursing lenders for defaulted loans, guarantee agencies are responsible for the collection of those loans. As default rates have skyrocked, however, guarantee agencies have found they can no longer rely on full reimbursement from the federal government. The guarantee agencies are, at first, reimbursed by the Department of Education for 100 percent of their claims paid to the lenders. But when the amount of their claims exceeds 5 percent of the loans in repayment of the end of the previous fiscal year for their portfolio, their reimbursement for subsequent claims drops to ninety percent. After the default claim rate reaches 9 percent, then only 80 percent of the agency's claims are reimbursed. In addition to default claims, guarantee agencies are directly reimbursed for borrower death, disability or bankruptcy.

To compound this scenario even more, the guarantee agencies automatically get a clean bill of health at the beginning of each fiscal year. As a result, it is to the agencies' benefit to delay default claims to the government into late in the fiscal year. This can be achieved two ways: delay reimbursement to lenders altogether, which is improper but has happened; and/or obtain short term balloon loans to cover the default payments to lender and delay the claim to the government. We found that, facing growing default costs, these delay tactics have been used by more and more guarantee agencies.

After the Department pays the guarantee agency the default claim, the guarantee agency remains the holder of the loan paper; the government does not become the owner of the loan note, even though the government has paid reinsurance. If the guarantee agency eventually collects from the borrower, the agency keeps 30 percent of the collection, while the taxpayer recovers at best only 70 percent. Mr. Chairman, this offers an incentive for the guarantee agency to defer initial collection on loans, recover the cost of the loan from the government, and then recover an additional 30% should subsequent collection efforts succeed. Further, for the first five years of a guarantee agency's life, it recovers 100% of its default reinsurance claims from the Department, regardless of its default rate. Several people have opined to the staff that policies and incentives such as these fuel the high default rate as well as the problems HEAF is experiencing today.

The Department assists guarantee agencies in the collection of these bad loans through the IRS tax offset program. This voluntary program permits the guarantee agency to refer, through the Department of Education, bad loans to the IRS for collection from tax refunds. No one we spoke with could explain why this program is voluntary, or why we wait until the taxpayer reimburses the loan to the guarantee agency before this step is taken. In fact, in 1988, GAO recommended that all guarantee agencies be required to fully participate in the IRS tax offset program.

Mr. Chairman, the Department and the guarantee agencies like to point out that subsequent successful collection on defaulted loans proves that sometimes the system works. We would like to point out that these collections should have occurred before tax dollars were used to reimburse the guarantors. The money was collectable, and was not collected. This situation obviously adds to program costs.

Much has been reported about the financial troubles facing the nation's single largest guarantor of federally backed student loans: the Higher Education Assistance Foundation. The Foundation, a non-profit corporation based in Kansas, has placed "its" guarantee on what now amounts to approximately $10 billion of student loans. Over time, most of those loans were made to students of for-profit trade schools, the group of borrowers that represent the highest defaulters on taxpayer backed student loans.

The Foundation now finds itself in deep financial problems because it aggressively guaranteed loans, on a nationwide basis, to students attending for profit trade schools. Because such a large portion of these loans are coming due and subsequently defaulting, the Foundation must reimburse the holders of the loans the full face value of the unpaid loan. HEAF told us that 47 percent of the proprietary school loans in their portfolio are defaulting. Moreover, approximately 80 percent of the loans originated by First Independent Trust Company (FITCO) and guaranteed by HEAF are defaulting. HEAF is required to attempt to get the loan in repayment status itself and failing that, which is too often the case, passes the claim onto the taxpayer. The Department of Education reimburses the guarantor based on the guarantor's past performance. Due to the high default rate on its loans, HEAF has only been receiving 80% of its claims back from the Department of Education. Although HEAF has been experiencing this problem for the past several years, it has until now been "propped up" through loans by lenders and the secondary market. Compounding past problems, the Department has also now refused to reimburse HEAF for a substantial number of loans originated by FITCO, due to alleged fraud and other irregularities in the servicing of those loans by United Education and Software (UES).

The Department, since news of HEAF's financial problems was made public, has been working on a solution to this problem. Initially, HEAF had proposed shifting the guarantee on some student loans to the Nebraska Guarantee Agency. Since the Nebraska agency is relatively new and under the five - year - 100 percent reimbursement schedule, the taxpayer would have paid for all the defaults in that portfolio, not just 80 percent. The Department balked at this proposal and is now considering alternative solutions.

It is now obvious that HEAF can no longer meet the obligations it made in the past. Unfortunately HEAF is not alone in that respect. The Department, once word of HEAF's troubles were made public, has been reviewing many other guarantors and is finding the same basic problem: poor management and oversight decisions, high default rates, and a change in program requirements have led to financial difficulties.

Shortly after the disclosures of HEAF's financial difficulties were made public, the Secretary of Education publicly announced that the Department was concerned with the financial stability of other guarantors as well. The Department has stressed that any similar difficulties faced by other individual guarantors, even when combined, would not equal the size of the problem of HEAF. With this said however, the staff notes that the Department has been forced into crisis management of a problem that should have been recognized years ago. The lack of in-depth program analysis and forecasting regarding the financial condition of these quasi-government sponsored enterprises has raised even more questions about the Department's ability to conduct effective program oversight.

The Department has given the staff a list of the guarantee agencies currently under scrutiny, but cautioned that just because an agency is being reviewed, does not mean that that agency is experiencing financial difficulties. The Department, therefore, has requested that the staff not make this information public. The department advised that all 16 agency reviews will be completed by September 30, 1990, and the financial status of those agencies will be known by that time.

We are not saying that all of the agencies face financial difficulty. But one thing is certain - guarantee agency trouble fuels the fire of criticism of the management of this program

This is not good news for the taxpayer. This is not good news for participating lenders. This is not good news for the secondary markets that raise money to buy loans so the lenders that sell their loans may make more student loans. Ultimately, this could mean bad news for our students and educators.

ABUSIVE SCHOOLS ARE NOT THE STUDENT'S ONLY PROBLEM

Our investigation found that many of the financial entities involved in the student loan program are far removed from any actual interface with the student. As a result, they are often indifferent to the interest of the student, the policy objectives underlying the programs, and, ultimately, the interests of the taxpayers. In short, they are oftentimes part of the problem, not part of the solution. Student borrowers can become the unsuspecting fodder of lenders seeking quick profit.

Mr. Chairman, the subcommittee has examined the problems associated with abusive trade schools. The schools can be just the beginning of the student's problem. If a school closes without a teach-out program at another school and does not reimburse the students for the unused tuition, the student is stuck with the loan. Most guarantee agencies lack policies and procedures to write-off bad loans. The Department of Education has issued guidelines to guarantee agencies, permitting but not requiring the write-off of loans to victims of closed schools, but most guarantee agencies have no attending policy or procedure. So, the student has no recourse but to pay back a loan for which he received nothing, or default on the loan. Too often, the latter happens, the school owners keep the tuition money, and the taxpayer picks up the tab.

Too often, student victims of school fraud, wherein the school employees forged the student's signature on the loan check and deposited the loan in the school's account, are held liable for the student loan. To aggravate the situation even more, some lenders strongly suspect the checks have been forged and continued to process the checks, leaving the unsuspecting student to later face defaults on their credit reports, seizures of their tax refunds, and harassment by collection agencies. Forgery affidavits have been submitted by students and ignored by lenders. In a specific case, IG investigators found that there were 835 students attending MBC Medical Educational Center in Tampa, Florida. During a file review, they found 617 checks that had been forged and another 200 that had not been endorsed by the borrower. The lenders paid all these checks. The lenders in this case were Glendale Federal and FITCO. In some cases, bank employees suspected the forgeries and did nothing.

Since the Subcommittee initiated this investigation last October, the staff has heard from numerous student loan borrowers. Among their complaints, students claim that deferment forms have been submitted to loan servicers and ignored; refunds the school claims were sent in were not posted to their accounts; the student is out of school and cannot determine who he should make payments to because the loan was sold and the student was never contacted by the lender; and once loans are paid off, lenders refuse to send a copy of the promissory note marked "PAID." Some lenders feel that a greater level of service is just too much to expect for a student loan.

SECONDARY MARKETS

During our investigation we found that the Department of Education simply does not regulate or oversee the guaranteed student loan secondary markets.

Originating lenders often sell the loans they have made before the loan matures and the student begins payment. The student loan secondary markets hold and service the loans through collection. Using tax-exempt, taxable, and/or State funding, the secondary markets provide liquidity for lenders, enabling them to make more loans. While the loans may be bought and sold on the secondary market, or change servicers several times, the original guarantee stays with that loan for the life of the loan.

Aside from the due diligence requirements, the Department has little interface with the secondary market. Moreover, the Department lacks specific authority to regulate or review the financial activities of most secondary markets. The way these secondary markets go about raising capital is not reviewed. Their profitability on financial soundness are not considered.

There are approximately 50 secondary markets for student loans in the United States. A copy of the 100 leading holders of student loans for FY 88 and 89 are attached to this statement as appendix E. The nation's largest holder of student loans is the Student Loan Marketing Association (Sallie Mae), a government sponsored enterprise. Sallie Mae holds $13.5 billion in student loans, and has provided the Subcommittee a statement for the record. The nation's third leading holder of student loans, the California Student Loan Finance Corporation is a principal player in our case study and will be discussed later. Their vice president will testify tomorrow.

This year the Department of the Treasury issued a report on government sponsored enterprises. I offer as an exhibit, a copy of the section of that report regarding Sallie Mae. The Treasury points out that "no federal agency has statutory authority to regulate Sallie Mae's business operations or its capital adequacy." The Department of Education does have responsibility to oversee Sallie Mae's servicing of student loans.

In February 1990, the Department of Education Inspector General advised the Department that there was a need to establish oversight of the nation's secondary markets, and pointed out that the law and program regulations do not even specifically define secondary markets. The IG went on to point out that:

> "Despite the overwhelming presence of secondary markets in the guaranteed student loan program, the Department of Education presently does not systematically receive and/or provide audit and/or program review coverage of these organizations. Our review also indicates that ED does not know how many secondary markets exist or whether anyone is evaluating their performance."

This report paints a dismal portrait of the oversight these entities receive. I offer it, Management Improvement Report No. 90-6, as an exhibit.

Mr. Chairman, the impact of the lack of oversight over investment vehicles offered by the secondary market is hard for us to gauge. The financial stability of these secondary markets, which ultimately insures the continued availability of student loan funding, aside from Sallie Mae, is simply unknown.

LOAN SERVICING

Our investigation found that as student loan volume has mushroomed, falsification of loan origination and collection information has occurred and has often gone undetected for long periods of time, at both loan servicing and lender operations. These problems can and do have a major impact on program costs and the collection of loans.

Many lenders hire third party loan servicing corporations to conduct the tedious task of tracking the millions of guaranteed student loans. Some lenders attempt this task on their own.

Improper loan servicing can be the downfall of any lender or guarantee agency and can ultimately place tremendous costs on the taxpayer. Sallie Mae is responsible for the servicing of $13.5 billion in loans. Financial considerations, coupled with the realization that a mistake by a contractor could ruin the Association, prompted a major decision to bring a large portion of their portfolio "in-house" for servicing. They have expended sizeable resources to construct facilities and procure the needed computer and communications equipment to meet this task. The Department is currently auditing Sallie Mae's servicing in Herndon, Virginia, but have not yet released their findings.

Our case study will cover what is probably the largest single loan servicing fiasco in the history of the student loan program. The staff wants to point out however, that the problems uncovered in that case are not an isolated case.

Consider, for example:

FLORIDA FEDERAL SAVINGS BANK of St. Petersburg, Florida, was at one time, the Nation's third largest originator of guaranteed student loans, and two of its former officers were found guilty of attempting to defraud taxpayers of $35 million by filing 17,000 false claims for reimbursement. The thrift collected $18 million in reimbursements before the Department froze other claims. Between November 1986 and July 1987, the bank and approximately 20 of its employees falsified required collection attempts on loan documents and submitted them as defaulted loans. Student borrowers testified during the trial that they had been willing to pay the loans in question, but were never contacted by the bank. In addition to the $35 million in loans effected by the false claims, another $85 million in loans, processed during the same time period, are in question.

BAYBANKS CREDIT CORPORATION, Boston, Massachusetts, pled guilty to federal charge that the bank engaged in fraud involving the falsification of documents related to the student loan program. The bank agreed to pay a $500,000 criminal fine and make restitution of $248,753 to the Department of Education. The case revolved around an investigation that disclosed that between January 1985 and July 1986, Baybanks submitted 76 falsified default claims to its guarantee agency. Bank employees forged, or were aware of forged, borrower signatures on loan related documents. The forgeries covered-up gaps in violation of due diligence collection activity. The investigation also disclosed evidence that Baybanks officers and employees were engaged in similar activity as far back as 1983. Allegedly, officers directed and encouraged the Bank's student loan collectors to fabricate computerized records of collection activities and corresponding paper files. Files and correspondence were backdated, and student signatures were traced from one document to another. These actions also covered-up improper due diligence gaps on the collection of delinquent loans. The information regarding the incidents from 1983-1986 was not part of the criminal case, and no administrative action has been taken against Baybanks for these very serious, intentional violations. In fact, the Department of Education, over the objection of the Inspector General, has so far declined to take such administrative action.

MITCHELL SWEET LOAN SERVICING (MSA). Is a privately owned student financial aid consultant and loan servicer. In July and August of 1988 a program review of MSA was conducted jointly by the Inspector General of the Department of Education and HEAF. It was concluded then, and reported again in a December 1989 IG audit of loan servicing procedures at MSA, that the servicer had "engaged in the systematic falsification of loan collection activities" from May through July 1888. The review further states that employees entered fictitious phone calls and backdated missing letters in system records to conceal that required due diligence steps had not been performed. This case was referred to the U.S. Attorney's office by the Department of Education Inspector General's office but according to the IG's office prosecution was declined.

HIGHER EDUCATION ASSISTANCE FOUNDATION. The Inspector General conducted an audit of HEAF, issuing a report in September 1988, based on files reviewed for the period March 10, 1987 - September 30, 1987. The IG concluded that HEAF's records did not document that the required collection procedures were performed for default claims paid to lenders during that time frame, and questioned $127.8 million in reinsurance payments to HEAF.

UNITED STUDENT AID FUNDS, Incorporated. Another IG audit of USAF and eight other guarantee agencies disclosed that USAF, on behalf of itself and the other agencies, violated Department requirements by failing to pay a substantial number ($25.3 million) of student loan default claims to lenders within the 90 days the claims were filed. A non-federal audit of the New York State Higher Education Services Corporation disclosed that $64.5 million was ineligible for reinsurance because of late payments to lenders. That audit also questioned $173.8 million because the guarantee agency could not verify that defaulted claims were litigated within 225 days as required.

UNIPAC/NEBRASKA. An IG audit of UNIPAC Service Corporation of Aurora, Colorado, disclosed that UNIPAC was late in cancelling 11,272 guaranteed student loans purchased from the Bank of Horton, by the Nebraska Higher Education Loan Program. These late cancellations resulted in the Department of Education paying $384,308 in excessive interest and special allowance.

PROFITS DRIVE PROGRAM VOLUME
AND
PROGRAM COSTS

The financial players in the student financial aid program quickly discovered that loan volume drives profits: profits not available through the Pell Grant program. Our investigation confirmed that this realization, coupled with a growing pool of schools to create that desired volume, has driven the growth, and subsequent costs incurred, in this program. Contrary to what some have suggested, we do not believe that the program has expanded to the extent it has merely because the student grant program decreased and student loans took its place.

By and large, the incentives the federal government pays to loan originators and loan holders in interest and special allowance, coupled with little, if any, practical financial risk, have created a desire for lenders to become involved and have kept the program alive. Without those payments and the profits realized, lenders would avoid being involved.

Lenders are paid, by the federal government, interest and special allowance before the student even enters repayment. Many lenders sell the loan to the secondary market before the loan enters repayment to avoid the costly and burdensome task of collecting the payments from the borrower. In most cases, the lender sells the loan above the face value. In the case we examined, the secondary market paid FITCO the face value of the loan plus one percent. FITCO's volume drove its income. The faster the secondary market could get its hands on the loan, the longer it would collect the easy interest and special allowance.

In fiscal year 1989, the taxpayer paid $2,618,000,000 to lenders in interest and special allowance. Because the special allowance payments are tied to the average 91 day Treasury bill, which was two points higher in FY 1989 (6.2% in 1988 and 8.2% in 1989) than in 1988, the program's special allowance payments were three times higher. It is clear what higher interest rates do to the cost of this program: a one percent increase in the T-bill average equates to at least $400 million in additional program costs to be paid to the lenders. We, the taxpayer, get no additional services for this added expense. Not only is this program very costly, the guaranteed student loan programs are, for all their participants, probably the most complex type of consumer loans in existence.

Guarantee agencies collect up to 3% of the loan amount from the borrower for the guarantee. The Department then pays guarantors 1% "administrative cost allowance" for new guarantees. Last year, the taxpayer paid $133 million in this allowance to the guarantee agencies.

In fiscal year 1989, guarantee agencies paid $2,021,715,223 to lenders on default claims, a 41 percent increase over fiscal year 1988. Taking account for subsequent collection on those loans and guarantee agency trigger rates on reimbursement, the taxpayer eventually shelled out $1,900,466,700 to reimburse the guarantee agencies for those defaults.

DEPARTMENTAL OVERSIGHT

As with other aspects of the program, our investigation found that the Department of Education's oversight of lenders, guarantee agencies, loan servicing operations, and secondary markets has proven poor. Poorer still is the Department's record of enforcement action once a violation has been discovered.

In defense of the Department's record, we were told that at the key time the student loan program was dramatically increasing, the Administration, disappointed that it could not dissolve the Department altogether, gutted it. As a result, the Department stopped training participants and slowed oversight visits. One guarantee agency employee in California told us that at the time, the Department's regional office only had enough travel money to buy bus tokens.

It is not difficult to find evidence of the Department's poor oversight. For example, as defined most eligible lenders are prohibited from doing the majority of their consumer lending in student loans. Nevertheless, our investigation revealed that for a time, both the Nation's number two and three originating lenders in the guaranteed student loan program were doing precisely that, in violation of Federal law. In our case study, we will see that only one of these lender's participation was ever seriously questioned - not by the Department of Education, but by a state banking department - in that case the Congress eventually changed the law to make the specific lender's violations legal.

Violations by the other lender, the Bank of Horton, were discovered by the Department's regional office, only to have the Department's managers in Washington enter into a questionable agreement with the bank wherein the Department effectively waived what amounts to a violation of federal law and regulation. Only this year did another Federal agency, the FDIC, finally step in and issue a cease and desist order against that bank's student loan practices. I now offer as exhibits, copies of the Department's agreement with the Bank of Horton, a subsequent Inspector General audit of that bank, and a copy of the FDIC's Cease and Desist order.

Under the Higher Education Act, pension plans "defined" by ERISA and insurance companies are also permitted to deal in student loans, and neither are constrained by the so-called 50% rule. We were told that insurance companies have been found originating loans as a means to find new insurance clients. As you know, insurance companies are regulated by State agencies, not the federal government. Pension plan investment is regulated by ERISA and is enforced by the Department of Labor. The Department of Education is only concerned with loan servicing and interest billings.

LENDER AND GUARANTEE AGENCY OVERSIGHT

We found, during this phase of investigation, that oversight of these program participants by the Department of Education has failed to adequately protect the student loan program from abuse. The system is late in arriving on the scene and slow to take adequate enforcement action against violators.

Loan originators and loan holders are subject to program compliance reviews by both the Department of Education and the guarantee agencies that guarantee loans of the lender. Prior to 1987, the Department used the same employees to conduct program reviews of schools, lenders, and guarantee agencies. Since then, offices have reorganized to permit "specialization" in either school or lender/guarantee agency program review assignments.

The following information, as reported by the Department of Education, depicts the number of lender reviews conducted by fiscal year of lenders by the Department and by guarantee agencies.

Fiscal Year	U.S. Department of Education Lender Reviews	Guarantee Agency Reviews of Lenders
1981	909	-
1982	802	-
1983	773	-
1984	763	-
1985	675	-
1986	463	*
1987	222	103
1988	282	544
1989	519	466

*Guarantee agencies' reviews of lenders were not tracked by the Department of Education prior to 1987.

These national numbers alone do not mean much, until you look at the actual regional offices which must review these operations, and understand the scope of the reviews that are conducted.

For example, the Department's regional office in Georgia is responsible for oversight in eight states, which include approximately 1200 lenders and 8 guarantee agencies. That office has five reviewers who travel the eight states. They spend, we were told, about 2 days reviewing each lender, reviewing about 35 borrower files and the forms 799. Guarantee agencies are generally reviewed for program compliance as well.

The Department's regional office in California is responsible for lender reviews in 14 states. Eight program officers (three are new and are training) oversee 11 guarantee agencies, fourteen secondary markets, and 729 lenders. In FY 89, they reviewed 100 lenders.

One former employee of that region told us that in 1988, there were only five reviewers for those 14 states. Three of the five had over 12 years experience, but, the former employee added, "Experience does not relate to competency."

Regional offices select lenders for review based on the volume originated or maintained by the lender. Therefore, we were told, the small lenders are often overlooked completely. Unlike participating schools, lenders do not have to submit independent audit reports or compliance audits of their loan program.

The General Accounting Office has been critical of the Department of Education's lenders reviews in the past. Quoting again from last week's testimony before the Full Committee:

> "To oversee lender activities, agencies should establish effective credit management standards for lenders. Agencies should also effectively monitor lender practices to determine whether these standards are being met and, therefore, whether lenders are following agencies' credit management policies and procedures. We have found, however, that agencies' programs to monitor lenders' practices are often weak...In January 1988, we reported that Education's on-site reviews of lender activities had decreased steadily--from over 800 lender reviews in fiscal year 1981 to fewer than 200 such reviews in fiscal year 1987. More recently, we reported that, by the end of fiscal year 1989, Education had increased its monitoring to 519 lender reviews, with a total of 700 additional reviews being conducted by its guaranty agencies during fiscal years 1988 and 1989."

Mr. Chairman, in addition to our findings, I offer as an exhibit, a copy of ED Inspector General Management Improvement Report No. 90-7, which details the results of an audit of the quality of oversight conducted by the Department and the guarantee agencies. This report is very critical and raises significant concerns regarding the very standards used in lender reviews.

Just as we found with participating schools, lenders are subject to some other regulatory scheme by outside official agencies. Reviews by the state banking departments and/or other federal government agencies are conducted but there is no requirement that the Department of Education attempt to obtain those other reviews or contact the other bodies to determine the other agency's opinion of the institution. Once again, information is not shared. We asked the Department program officials about this here in Washington. Their opinion was that there was too much work to do already. They told us that they don't want to have to ask for more data (even though the institution would have copies of the other reports on hand) and cautioned that most Department employees wouldn't understand the banking reviews in the first place.

I believe that our case study will show that if all the oversight bodies involved had just talked to each other at an early date, the problems at First Independent Trust Company would not have grown to the extent that they did.

The Department relies on its regional offices to conduct all the reviews and oversight of the lenders in each region. These officials generally review the special allowance and interest billings but do not determine what schools the lender is participating with. The Department, when it finds problems with lender billings, makes adjustments in subsequent payments, but does not levy administrative fines on the participant. In other words, if caught, most of the time, the Department just requires compensation without penalty. This practice invites shortcuts.

REGULATORY ENVIRONMENT

We were told by Department employees that the "program is so complex" and "the law and regulations change so often" that it is impossible for participants to do everything correctly all of the time. They also told us that the law and regulations are frequently changed before anyone can tell if the previous regulations were working or not.

The Department of Education has yet to issue the implementing regulations for the changes made to the Higher Education Act in 1986. The Department was successful in issuing the regulations from the 1981 reauthorization of that law in 1986, just weeks after the Act was again reauthorized. The program's participants are continually subject to a wide array of complex law, regulations, and Departmental "Dear Colleague" letters which all tend to confuse those participants.

Mr. Chairman, these players should be part of the default management solution. Never should they be, as our investigation found, part of the problem. Banks should use care in deciding who they lend money to: but they don't have to care when its a guaranteed student loan. There is no credit check, no co-signer, no collateral. If they don't care about requiring those normal lending safeguards, they also have no reason to care if the borrower will get a quality education with the loan.

Mr. Chairman, we interviewed former bank employees and criminal investigators who told us that bank employees sometimes know that a student's loan check was forged, because there is so little similarity between the student's signature on the loan application and the signature on the check's endorsement. This, one would hope, would lead to a subsequent investigation. We were told it did not. At FITCO, employees brought this to their manager's attention, and were told to forget it ever happened. Since there is little risk, there is little reason to safeguard either the borrower or the lender from error in making the loan. Since volume drives the profit which seems to drive the system, there is a motive to write any loan, however obvious the risk to the taxpayer may be.

GAO has also determined that some of the macro level problems in the management and oversight of these programs have reached OMB, and that OMB is studying and recommending action on the issue:

> "OMB recently began to stress resolving problems related to agencies' guaranteed lending operations. For instance, in a June 1990 report to the Congress on the status of credit management and debt collection, OMB stated that, while guarantees make the government ultimately liable for loan defaults, agencies have not historically viewed management of guaranteed loans as their direct responsibility. They have not provided strong oversight of lenders, guarantee agencies, and other third parties interacting with the borrower on behalf of the government. OMB commented further that agencies have not been rigorous in setting and enforcing lender requirements and in monitoring lender performance. At the same time, many lenders knowing that the loan repayment is guaranteed, have not been diligently screening applicants and servicing accounts or aggressively pursuing collection."
>
> "To help correct these problems, OMB has proposed a nine-point program aimed squarely at guaranteed loan management. This program would guide all aspects of loan guarantee operations from establishing lender standards and monitoring lenders to screening loan applicants. Also, to produce accurate and consistent data on guaranteed loan program operations for use in making informed decisions thereon, OMB's proposed program would require annual audited financial statements of credit programs."
>
> "In addition, the Department of the Treasury completed in June 1990, a comprehensive, governmentwide assessment of guaranteed loan management. Agency guidance and oversight of lenders was a specific emphasis of the study, which found wide disparities in program standards and operations among agencies and concluded that agencies provide only general guidance to their guarantee lenders and exercise minimal oversight. Treasury's assessment report contained nearly 100 governmentwide or program-specific recommendations and proposed standards for better managing lenders and servicers and monitoring their performance."

> "One way the Treasury study suggests for improving lenders' performance is to require them to share a greater amount of the risk involved in the loans the government guarantees. A lender might, for example, be responsible for 20 percent of a loan loss, while the government's share would be 80 percent. Treasury's belief is that not having all or the majority of the risk borne by the government would also ensure greater diligence on the part of the lender in making and collecting loans. As envisioned by Treasury, lenders would be encouraged to shoulder more of the risk burden if paperwork and review requirements for guarantee programs were reduced to the minimum necessary for proper program operations."

CASE STUDY

FIRST INDEPENDENT TRUST COMPANY (FITCO)

Mr. Chairman, the staff has selected for its case study an incident which occurred in California, but has had major ramifications throughout the country's educational and financial arenas and even in some foreign financial markets. This is a matter that remains unresolved and is being heavily litigated. It represents what can happen in government sponsored programs when there is little effective oversight combined with readily available funds and delayed reactions by regulators. The case study examines the nation's second largest originator of student loans; this lender's secondary market located in California; the nation's largest guarantor of student loans; foreign and domestic banks as well as the U.S. Department of Education. There are also many victims in this case study who have gone unaided, while to date, the culpable parties have hardly been chastised.

AN HISTORICAL PICTURE OF CALIFORNIA'S FIRST DIRECTED TRUST COMPANY REVEALS POOR MARKS FROM THE BEGINNING

In 1975, First Independent Trust Company (FITCO) opened in Carmichael, California, under a charter from the California State Banking Department, as the state's first directed trust company. FITCO's charter resulted from the pressure of a law suit filed by FITCO against the State Banking Department who had attempted to deny the charter. FITCO was developed under the direction of its first and only president, Deno Evangelista, and several other founders who oversaw the principle business of serving as trustee of various retirement plans and other fiduciary accounts. Evangelista told the Subcommittee staff that when FITCO opened, there were approximately thirty-five stockholders in the publicly held corporation. The majority of the stock in FITCO was held by its parent company, the Lawyers Financial Corporation, of which Evangelista is also the president. FITCO's operating capital initially came from this parent corporation.

According to California State Banking Department reviews, FITCO, from its inception, received poor marks for its business operations and was consistently short on operating capital. Despite these facts, in 1980 FITCO was given a lender identification number by the California Student Aid Commission (CSAC) and allowed to participate as a lender in the federally guaranteed student loan programs. A copy of this agreement with CSAC as well as FITCO's 1981 agreement with the Department of Education are offered as exhibits. FITCO's loan volume grew to the extent that it became the largest lender of guaranteed student loans in California as well as, for a time in 1987 and 1988, the second largest lender of student loans in the United States. FITCO is estimated to have originated approximately $1.5 billion in student loans in its nine years in the program.

FITCO, a trust company that was not insured for state banking purposes but operated under the guidelines of a state chartered bank, had no backing by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), nor was it a member of the Federal Reserve System. Therefore, FITCO was not subject to review by federal bank examiners. Subcommittee staff was told that until FITCO's participation in federally guaranteed student loan programs, the trust was monitored solely by the California State Banking Department. In May 1989, FITCO was declared insolvent and closed by the state banking officials after suffering crippling financial losses during 1988 and the first quarter of 1989. The Acting Superintendent of Banks, Harold Doyle was quoted saying, "It was necessary to close the trust company as a protection to customers, creditors, and the public." At the time FITCO was declared insolvent, it had in the first five months of the year already originated nearly $49 million in student loans, making it the 48th largest lender of student loans for all of 1989.

FITCO's unsound business practices, including those related to the student loan program, have had a domino affect throughout the student loan community resulting in losses for thousands of investors, skepticism about the viability of the student loan program as it exists today and certainly a black eye for the Department of Education.

PARTICIPATION IN STATE BANKING PROGRAM AND FEDERAL STUDENT LOAN PROGRAMS ALLOWED DESPITE UNSOUND BUSINESS PRACTICES

In 1979, prior to participation in the Guaranteed Student Loan (GSL) Program which today is comprised of Stafford, Parental Loans to Undergraduate Students (PLUS) and Supplemental Loans to Students (SLS), FITCO participated in federal student loan programs, FISL (Federally Insured Student Loans) and NDSL (National Direct Student Loans). Evangelista told the staff that in 1979 he developed an interest in the GSL program and the following year contacted the California Student Aid Commission (CSAC), the state guarantee agency, to obtain a lender identification number. The Department of Education has entrusted the fifty plus guarantors across the nation with the ability to determine who or what constitutes an eligible lender and to issue lender identification numbers to those they choose to do business with. In April of 1980, FITCO was given the number and as a state chartered trust company became eligible to buy, sell, originate and hold student loans.

According to Evangelista, when FITCO entered the student loan program there were approximately thirty employees at the trust company and loans were made only to students attending school in the Sacramento area. As CSAC provided schools with the names of lenders participating in the student loan program, FITCO was able to increase its loan volume. When these schools contacted FITCO concerning loans for their students, FITCO representatives would visit the schools and make presentations of the services they had to offer. It was not long before the trust company began to make loans to students throughout California.

FITCO derived its capital by investing customers' funds in some very common ways such as IRAs, KEOUGHs and real estate. It also profited from general management of trust accounts, corporate pensions, and court accounts that were awarded to the company for management from probate court. FITCO later established what it called Trust Rate Accounts as a sort of replacement of the Common Pool Trust Fund. The Common Pool Trust Fund, advertised as investments in secure government holdings, was dissolved when the California State Banking Department realized in August of 1980 that FITCO, a trust company and not a commercial bank, was improperly concealing the percentage of profits that were made on investors' money. According to a former employee of FITCO from whom the Subcommittee has obtained a sworn statement that is offered as an exhibit, at times capital from the Common Pool Trust Fund was used to make student loans. When this fund was dissolved, FITCO needed another source from which to fund student loans and thus created Trust Rate Accounts.

Beginning in 1983, FITCO investors were encouraged, through somewhat misleading advertising, to invest in its Trust Rate Accounts for the purpose of providing student loans. Such advertising, examples of which are attached in the appendix to this statement, and one of which is displayed, was criticized by the California State Banking Department in its 1985 and 1986 reviews. This advertisement reads:

> "First Independent Trust, The Intrust Bank"
>
> and
>
> "The guarantee on Trust Rate is the full faith and credit of the U.S. Government, which is exactly the guarantee given if you were to purchase T-Bills. Also,

> the full faith and credit of the U.S. Government is the highest priority guarantee for a financial instrument; safer than the FDIC or FSLIC which are secondary to the full faith and credit of the U.S. Government."

In fact, these Trust Rate investments were not always used for the purpose that was intended. According to state banking records and interviews the Subcommittee has conducted, we have learned that numerous unsecured loans were allegedly made to Evangelista's influential friends and associates from these Trust Rate accounts. These sources have also revealed that money from the corporate account was often comingled with that of the Trust Rate Accounts.

When FITCO first became active in the GSL program, there was no secondary market in which to sell the loans. Therefore, FITCO held the student loans and was responsible for servicing the loans, or performing due diligence on them so the loans could retain their insured status from both the guarantee agencies and the Department of Education. As the number of student loans originated by FITCO increased, servicing of the loans in a timely manner became more and more difficult for the trust company.

When the secondary market in California did develop, FITCO's loan volume grew tremendously. In April of 1985, FITCO entered into an agreement with the California Student Loan Finance Corporation (CSLFC) to sell CSLFC student loans originated by the trust company. A copy of this agreement is offered as an exhibit.

As a point of reference, as loan volume continued to increase, the student loan department at FITCO grew from five to nearly ninety people. As the demand for student loans from FITCO increased, its ability to initially fund the loans from its trust resources was exhausted. It became a necessity for FITCO to immediately sell its student loans to the secondary market in order to generate capital to originate additional loans. The staff has been told that in the beginning FITCO sold its loans within a week but as its volume grew, the loans were sometimes sold the same day or even within hours.

Officials at CSLFC told investigators that FITCO was always looking for a way to increase the speed at which it could sell its loans. This later resulted in problems for the trust company in that the short time frame often did not give the student who had decided not to attend school the opportunity to cancel his or her loan before it was sold. This led to the further problem of loan cancellations not being forwarded in a timely manner to the institution, usually CSLFC or its servicer, owning the loan paper.

To increase the speed with which it could make loans, FITCO provided schools with free computers to use in-house to process loans made from FITCO to their own students. 600 schools in 43 states were provided PCs and FITCO software to process the students' loan applications. The applicant's information was sent, via modum, to the trust company which then forwarded it to a guarantee agency. Once the guarantee agency approved the insurance on the loan and provided, in "hard copy" its approval, FITCO federal expressed the loans to the school.

In 1987, Jack Keefe, the Western Regional Director for the Department of Education cited FITCO for this practice as an inducement, a violation of the Higher Education Act of 1965, as amended. FITCO continued to provide the computers to schools but began billing them for the use. Evangelista said these fees were collected but we have yet to see any evidence of these payments.

United Education and Software (UES) is a corporation that, in addition to servicing student loans, produces education related computer software and operates a chain of proprietary schools based in Los Angeles. According to Aaron Cohen, President of UES, in 1984 UES signed a contract with FITCO to "front end" student loan applications. This contract is offered as an exhibit. Under the contract, UES would actually make the loans for FITCO, using the trust company's money. Since UES had no lender identification number to make the loans to students attending its schools, it obtained the loans through FITCO. The Subcommittee staff has found that origination of loans by UES to students of its own correspondence courses appears to be a violation of federal regulation. We submit for the record two letters from Jack Keefe and Aaron Cohen, addressing this issue. It is unclear from the statement written by Cohen and signed by Keefe if the two men interpreted Cohen's question in the same manner. This interpretation could clarify why Keefe gave his approval of what appears to be a violation of the regulations. We recommend that these letters be addressed by these witnesses tomorrow so that the Subcommittee may clearly understand how and why UES was able to originate these loans to its own students.

Evangelista contends that the Department of Education knew UES was "cutting the checks" for FITCO, both to students of its own schools as well as other schools, and he admitted that many loans were originated in this fashion. UES was then in turn servicing the loans it had originated through FITCO, for CSLFC, which had directly purchased the loans from FITCO. Cohen admits that with the increased loan volume coming from CSLFC to the servicer, it became a task in itself for the servicer to keep up with the flow of work. In effect, UES was exasperating its own problems by originating more loans.

In addition to CSAC guaranteeing a significant amount of FITCO's loans, the Higher Education Assistance Foundation (HEAF), a national guarantor, also did a great deal of business with FITCO. In 1985, the two entered into an agreement in which HEAF guaranteed loans valued at nearly $900 million to students attending 898 different eligible institutions. This contract is offered as an exhibit. In 1989, HEAF, as a result of its program review, decided to suspend and finally terminate its agreement with FITCO regarding participation in the student loan program. This is offered as an exhibit. HEAF cited six ongoing violations that were "of such seriousness and magnitude" that substantial losses to the borrowers, HEAF and the Department of Education were likely. These violations included, among other things, numerous refund problems, failure to pay outstanding guarantee fees, and failure to file quarterly interest and special allowance reports or pay origination fees.

When making a Stafford loan to a borrower, an origination fee is usually deducted from the loan and paid to the Department of Education. This fee is 5% of the principal amount of the loan. Also, an insurance premium is deducted from the loan and is forwarded to the guarantee agency that is insuring the student loan. This fee may vary but is generally 1%- 3%, but never more than 3%, of the principal amount of the loan. The employee we obtained the affidavit from stated that at FITCO, both of these fees were taken out of the student's loan and maintained in separate accounts for payment to the appropriate agency. Origination fees owed to the Department were in an account called "G.O.F.", for Government Origination Fees.

Origination fees are usually collected as a result of an offset between origination fees and interest and special allowance. Interest and special allowance are used as incentives to encourage lenders to make loans available to students. In the vast majority of cases, the interest and special allowance the Department owes to a lender is greater than the origination fees and when the two offset one another, the Department then owes money to the lender. These dollar amounts are determined each quarter when the lender submits to the Department a Form 799.

According to FITCO employees who spoke with us, FITCO filed its quarterly 799s in a timely manner from 1981-1986. After this time, reviews and audits indicate that the trust no longer regularly submitted the forms. In fact, the staff has found that FITCO did not submit 799s for certain quarters of 1986 or certain quarters of 1987 until forced to do so by the Department nearly a year after they were due. In 1989, HEAF also noted that FITCO had not filed the forms for the last two quarters of 1988 or the first quarter of 1989. CSAC noted that the forms were not properly submitted in two of its reviews. No penalties were levied by any agency for FITCO's failure to file.

To further this problem, it appears that FITCO did not file timely 799s for a good portion of its loans originated by UES. Department of Education records, offered as an exhibit, show that from the last quarter of 1984 through mid 1986, 799s were not filed until December of 1986. The final quarterly 799 for 1986 was not filed until December of 1990.

Again, the dollar amounts owed between the parties is determined from the 799 forms. As was mentioned earlier, most lenders owe less each quarter to the Department in origination fees than are in turn owed to the lender for interest and special allowance. However, this was not always the case with FITCO. Because FITCO was quickly selling the large volume it originated, very little interest and special allowance was allowed to accrue. As loan volume grew, the origination fees owed to the Department continued to mount and were great enough to never be offset by the interest and special allowance. This occurred in 1984 and continued throughout most of FITCO's existence. Records the staff was able to obtain indicating payments were owed to the Department date back to 1984 and continue to reflect this annually, throughout the remainder of the trust company's existence.

According to Evangelista, when it was first discovered by FITCO that FITCO owed the Department origination fees over and above the interest and special allowance it was due, FITCO mailed to the Department a check for $16,000. Again, the Department was used to the offset method of payment and accounting for these funds. It was not accustomed to receiving actual money and thus could not process the incoming funds. The check was returned to the trust company and FITCO was told to hold on to the payment with the hope that eventually the amounts would offset. Evangelista said that on another occasion FITCO tried to pay the Department its origination fees but again the check was returned. Department officials have admitted to staff that this could very well have occurred, but have no official record which would confirm it. One former FITCO employee stated that up until the time she left FITCO in 1986, the trust company regularly submitted its 799s indicating it owed the Department money, yet paying none. According to records in the staff's possession, the Department knew as early as 1984 that FITCO needed to pay origination fees yet it did not aggressively attempt to collect this money until the late 1980s, when a guarantee agency cited the alarming problem.

As was stated earlier, origination fees were taken from the student's loan and deposited in the G.O.F. account. We were also told that Evangelista had moved this account to the Bank of America where it was deposited in an interest bearing account allowing FITCO to collect interest on money that in fact belonged to the Department. Today the actual dollars that were withdrawn from the students' loans for these fees cannot be accounted for, dollar for dollar. One former FITCO employee told us that when capital at the trust company was scarce, FITCO officials withdrew funds from the G.O.F. account and used the money for interest payments to its trust rate clients and for other corporate liabilities.

There remain other outstanding concerns as a result of FITCO's failure to pay the Department for missing origination fees: What is the actual amount of dollars due the Department for the missing origination fees; who will be held accountable for the payment of these fees; what is the status of the student loans as far as federal reinsurance if the origination fees were not paid;

and why did it take so long for oversight personnel to discover and act on what has become a very significant aspect of the FITCO story. Jack Keefe, in a March 1990 statement to the trustors of FITCO, reported that the Department became aware of a significant number of problem loans originated by FITCO as early as 1985. Nevertheless, a year later FITCO was still able to further exacerbate problems, right under the nose of the Department, by delaying or not submitting its 799 forms.

Estimates of the amount of origination fees actually owed to the Department by FITCO varies from source to source and even varies from office to office within the Department of Education. A 1989 HEAF review of FITCO's general ledger revealed for 1988 alone, the trust owed more than $4.6 million in origination fees while the California State Banking Department, as liquidator of FITCO, has agreed on a settlement of $4.4 million with the Department to satisfy total outstanding origination fees. The General Accounting Office estimates FITCO owed $5.5 million in unpaid fees. Additionally, FITCO trustors have told the Subcommittee staff that although FITCO operated until May of 1989, the last origination fee that was paid by the trust company was in 1988, retroactively for 1987.

As mentioned earlier, FITCO was cited on numerous occasions by the Department of Education, The Higher Education Assistance Foundation, California Student Aid Commission and the California State Banking Department for problems associated with refunds and cancellations. For instance, we were told by a former FITCO employee that in 1986 she discovered that a large number of cancelled student loans and loan refunds had not been forwarded to the secondary market.

A loan is normally cancelled if the borrower decides not to accept the loan or not to enroll in school. If a potential borrower does not enroll in school, he or she is not eligible to receive a GSL. Schools are supposed to send unclaimed loan checks back to lenders so that the loans can be cancelled and the student's account credited. As long as the loan remains in the lender's inventory of loans, or investment portfolio, the Department pays interest and special allowance on it each quarter. In the FITCO case, delays associated with removing loans from the investment portfolio resulted in excessive interest and special allowance being paid to FITCO on the cancelled loans. This almost certainly resulted in credit problems for "borrowers" who never actually received loans.

Mr. Chairman, we have found that loans were made to students that should have been cancelled for any number of reasons. FITCO, in fact, was either so late in forwarding the cancellations, or altogether failed to process the cancellations that some of these "loans" have defaulted causing the Department of Education to pay reinsurance to the guarantee agency -- even though the loan was never actually accepted by the student. The

Department also paid special allowance and interest benefits on those loans to CSLFC.

Refunds were also due students who left school before the term was complete and thus were not accountable for the full tuition. Our FITCO employee discovered $1.8 million in refunds and cancellations that needed to be forwarded to the appropriate holders of the loans. When this request for $1.8 million was made to the accounting department at FITCO, the request was denied because the money was not accessible. The employee was told by the accounting department that the funds were tied up in corporate certificates of deposit that had not yet matured. This is not the only occasion that comingling of funds at the trust was brought to the staff's attention.

The staff has also learned that FITCO was originating new student loans from the refund money that it had not yet forwarded to the secondary market. This money, that should have been refunded, was placed in a noninterest bearing account at Security Pacific National Bank by day and swept out by automatic transfer to an interest bearing account each night. In this way FITCO could make money on money that was not its own. A record of such transactions is offered as an exhibit. We have also learned that the trust company used this refund money to pay some of its corporate expenses.

Given these internal problems, FITCO's overall performance in the GSL program is not surprising. HEAF has reported that its FICO paper has defaulted at a rate of approximately 80%. 96% of HEAF's FITCO originated paper was comprised of loans to students attending proprietary schools while 68% of CSAC's FITCO paper was to students attending for-profit trade schools. This is important to consider because several in the oversight role cited the trust for lack of due diligence in the making of a student loan, a requirement of the Higher Education Act.

LEGISLATIVE CHANGES CONFIRM FITCO'S ELIGIBILITY TO PARTICIPATE IN FEDERAL STUDENT LOAN PROGRAMS

The California State Banking Department, in 1985 and 1986 questioned FITCO's eligibility to participate in the GSL program given its apparent failure to satisfy the statutory requirements. Despite reports by state regulators of problems in FITCO's operations, Congress subsequently specifically changed the law so that FITCO's eligibility to participate would go unchallenged.

Until the 1986 reauthorization of the Higher Education Act of 1965, FITCO and other trust companies were not specifically included in the definition of "eligible lender" as defined in 20 USC 1085, which then read as follows:

> (g) (1) Except as provided in paragraphs (2),(3), and (4), the term "eligible lender" means -
> (A) a National or State chartered bank, a mutual savings bank, a savings and loan association, or a credit union which -
> (i) is subject to examination and supervision by an agency of the United States or of the State in which its principle place of operation is established, and
> (ii) does not have as its primary consumer credit function the making or holding of loans made to students under this part unless it is a bank which is wholly owned by a State;

A separate section of the law, did allow trust funds to be invested in student loans. In 20 USC 1076:

> Insurability of loans made from funds owned by lender or held by lender in trust.
> Loans made by eligible lenders in accordance with this part shall be insurable by the Commissioner whether made from funds fully owned by the lender or from funds held by the lender in a trust or similar capacity and available for such loans.

In 1986, Congress amended both of these sections of the Higher Education Act. The term "a trust company" was included in the definition of eligible lender. Congress went even further that year and gave First Independent Trust Company a specific waiver excluding it from the primary consumer credit prohibition section by adding:

> or (III) it is a trust company which makes student loans as a trustee pursuant to an express trust and which operated as a lender under this part prior to January 1, 1981;

Prior to those changes, FITCO did not appear to fit the statutory requirements for participation in the program. Nevertheless, with Department of Education approval, FITCO operated for several years as one of the nation's leading lenders in the program. Moreover, when the California State Banking Department raised the statutory question in 1985 and 1986, FITCO apparently sought and secured statutory change tailored to legitimize FITCO's participation in the program. This was done at a time when regulators had already made numerous findings of problems and irregularities at FITCO.

Mr. Chairman, the staff set out to discover why FITCO received such favorable treatment by the Congress during a time when its regulators knew it was not performing many of its practices in a sound manner. Staff at the Department of Education said they did not know why the law was changed and did not comment on the legislation.

According to the American Law Division of the Congressional Research Service:

> "The language, 'stock savings company, trust companies' was added to amend what was then subsection (g)(1)(A) by the bill reported out of the Senate Committee on Labor and Human Resources as a substitute to the original version of S. 1965. An amendment to subsection (g)(1)(A)(ii), adding 'and unless it is a trust company which makes student loans as a trustee pursuant to an express trust.', was introduced as part of a package of clarifying and technical amendments to the Committee substitute during consideration of S. 1965 of June 2, 1986. The amendments were offered by Senate Labor and Human Resources Committee. Language, including in subclause (III) the requirement that the lender 'operated as a lender under this part prior to January 1, 1981', was presumably added during the Conference Committee markup, since it was not included either in S. 1965 or H.R. 3700 as passed by their respective chambers before conference."

Deno Evangelista and Jon Smock, FITCO counsel and board member, told the staff that in 1985, the California State Banking Department questioned FITCO's participation in the student loan program, citing the lack of a specific provision for trust companies to make guaranteed student loans. Evangelista said that because the trust company was chartered by the State Banking Department and had to abide by the banking regulations, FITCO considered itself to be a state chartered bank. The banking department did not agree.

According to Smock and Evangelista, FITCO sought out several private legal opinions, all indicating that if litigated, more than likely the court would determine that trust companies were eligible to participate in the student loan program. However, Evangelista said that he felt it would be easier to get the federal law changed than to litigate the issue. An employee of the California State Banking Department told the staff that, at the time, everyone got a good laugh at Evangelista's intentions.

Evangelista said FITCO hired two Washington, D.C. law firms to lobby Congress on FITCO's behalf.

The staff learned that the California Student Loan Finance Corporation, FITCO's secondary market, also had a strong voice in supporting FITCO's participation, and hired a consultant to lobby Congress.

CSLFC was concerned that if FITCO were not allowed to continue to participate in the student loan programs, loans would not be available to CSLFC to fill the bonds it had issued.

Evangelista's prophetic announcement that it would be easier to have the law changed than to litigate the issue, turned out to be factual. Congress, apparently persuaded by input from CSLFC and CSAC that FITCO was doing a good job, ended discussion of the matter. This change had a chilling effect on the State Banking Department's staff, who were in awe of Evangelista's apparent power and connections when the provision was signed into law.

OVERSIGHT BY STATE REGULATORS AS A PRECONDITION FOR PARTICIPATION- IS IT ADEQUATE AND/OR IS IT MISPLACED?

As was mentioned earlier, the California State Banking Department gave FITCO its banking charter in 1975. There was considerable concern on behalf of the Banking Department regarding the operation of the trust in the banking system and the charter was denied until the trust pressed the legal issue. Once the charter was approved, FITCO fell under the guidelines of the California State Banking System. There was no federal regulation because the trust did not participate in any type of federal insurance program.

When FITCO began to participate in what is now called the Stafford loan programs, FITCO still was not insured by the FDIC or the FSLIC and there still was no federal banking oversight. This continued to be the case throughout FITCO's existence despite the more than $1 billion in student loans FITCO originated that the U.S. Government was ultimately responsible for. The staff questions the logic behind this lack of regulation of federal money.

The California State Banking Department has been the most consistent of all regulators in reviewing the trust company. According to records reviewed by the staff, from 1975-1988 the banking department conducted nearly annual reviews of FITCO with the exceptions of 1982, 1984, and 1987. Those reviews are submitted for the record. Of these eleven reviews that the staff has obtained, none present a promising picture. In fact, several of these reviews were quite damning. Despite that fact, the trust company was allowed, even without being fined, to continue to operate under California banking laws, as well as in federally insured loan programs. While we are critical of the banking department for allowing FITCO to continue to operate, we are also critical of the federal system for relying so heavily on state regulators as a precondition for participation in this federal program. The U.S. Department of Education, clearly having an oversight role related to the federal student loan program, fell miserably short as a regulator of its own program.

U.S. DEPARTMENT OF EDUCATION FAILS MISERABLY AS A REGUALTOR OF ITS OWN PROGRAM

At our request, the Department of Education, both headquarters and regional offices, provided to the Subcommittee staff its reviews and working papers concerning the trust company.

Despite FITCO's reign as one of the top lender's of student loans in the country and the recognized problems it was having, the Department conducted only four reviews from 1981-1989. These reviews combined, total fewer than 15 pages with only a relatively limited number of findings. We now submit these reviews for the record. Our examination of reviews conducted by other bodies confirms that the problems previously mentioned continued to exist at FITCO during the time the Department did its reviews. Yet, it was FITCO itself who pointed out to the Department that FITCO owed origination fees and, after being alerted to such, the Department of Education still allowed FITCO to operate in the program without submitting its 799 forms without collecting the outstanding origination fees. Again, these are the very forms indicating such basic information as the number of loans originated quarterly and the dollar amounts owed in origination fees and interest and special allowance.

In the Department's first review of student loan activity conducted in 1981, only two findings were made as can be seen from the chart. These findings include nearly $13,000 in insurance premiums that had not been paid and a $200 refund that had not been credited to the students account, as noted in Appendex I of this statement. Both of these findings continued to regularly occur, in some fashion, throughout the existence of the trust company. A close examination of all reviews of FITCO show this pattern of recurring problems. Additionally, the guarantee agencies having oversight of FITCO have made it clear that had the Department asked to see their reviews or to be notified of significant problems, they would have gladly complied. It was not until adverse conditions at FITCO had reached an absurd level that any of the regulators involved began to communicate their concerns.

As problem after problem developed with FITCO's increased student loan volume, the Department's recognition of and action on the problems did not correspond. While some corrections were made in the company's advertising and certain inducements were eliminated, little forceful action of major issues was taken by the Department until 1988 when it aggressively sought payment of past origination fees and submission of delinquent 799 forms. Even with these steps, the Department's settlement of $4.4 million for origination fees may represent only a slap on FITCO's hand.

The Department has admitted that this dollar amount is based on a "guesstimate" from another source.

Moreover, our examination found a lack of investigative incentive regarding the FITCO fiasco at the Department's Inspector General's office. Neither that office nor the FBI is conducting any type of criminal investigation into the operations of the trust company or its officers. However, in California, the State Auditor General recently began an audit of FITCO, and the California Banking Department has filed a civil suit against FITCO's officers. Records regarding this civil suit are offered as an exhibit.

FITCO'S SECONDARY MARKET: CALIFORNIA STUDENT LOAN FINANCE CORPORATION (CSLFC)

Mr. Chairman, the staff has found that FITCO's secondary market failed to adequately check the loans it purchased from FITCO and UES on behalf of FITCO; failed to safequard the guarantee on those loans through proper servicing; failed to properly bill the Department of Education for interest and special allowance for the loans in its portfolio; and failed in its fiduciary responsibility to the student borrowers whose accounts it maintained.

CALIFORNIA STUDENT LOAN FINANCE CORPORATION (CSLFC) HISTORY

The California Student Loan Finance Corporation (CSLFC), is a "nonprofit public benefit corporation that operates exclusively to acquire student loan notes incurred under the Higher Education Act of 1965, as amended." Its initial financing and acquisition of student loans as what is commonly called a secondary market, began in October of 1981. The founder of CSLFC, Jay Olins, told the staff that California needed a secondary market because there was no one in the state who would purchase paper of students attending vocational or proprietary schools. He stated that the Student Loan Marketing Association, Sallie Mae, which operates across the country, was only interested in purchasing the loans made to students of four year institutions. Olins worked with the Governor Jerry Brown's office to get the program chartered through the state of California. The Bank of America became CSFLC's corporate indenture trustee.

In 1982, after CSLFC sent letters to lenders throughout California stating the nondiscriminatory nature of its purchasing, its business began to grow. CSLFC purchased student loans from eligible lenders, generally arranged them into bond packages worth $75-$100 million and set up an indenture for each bond offering. As depicted in the appendix, CSLFC, as of September 1989, was the third ranking holder of guaranteed student loans in the country, responsible for $1,147,000,000 of borrowed principal.

Letters of Credit from various banks, primarily foreign, were obtained and proved critical in that they provided financial security for CSLFC to purchase additional student loans. These bonds were marketed by major brokerage firms such as Goldman Sacks. The tax exempt status, interest and special allowance from the Government, the federal government's guarantee on the student loans, and the Letter of Credit backing from some of the largest banks in the world made these bonds very attractive. CSLFC later switched to taxable bonds.

CSFLC signs purchase agreements with each lender before buying the loans. Before each of these sales, the lender agrees to give a "seller certificate" to the secondary market or the servicer performing due diligence on the loans. A seller certificate, among other things, confirms that guarantee fees and origination fees have been paid on the loans. On the other hand, a "servicer certificate" certifies that everything that was to have been sent to the servicer was received.

CSLFC signed an agreement with FITCO to buy its student loans in 1986. The agreement contains a reference date of May 1, 1985. This agreement is offered as an exhibit. FITCO agreed to sell the loans at face value plus 1%, with the understanding that if the student's loan was cancelled, FITCO would return the 1% fee to CSLFC. Olins said FITCO always wanted to sell its loans faster which was a bonus for CSLFC. Because the students were in school, the cost of servicing the loans was very little and CSLFC could collect the interest and special allowance on the loan. We were also told that 22-25% of the CSLFC's 1989 portfolio was made of cancelled loans or loans due partial refunds. CSLFC contends that FITCO owes the corporation nearly $10 million in overall claims. CSLFC also contends that the trust company was paying its corporate expenses from this refund money that was due CSLFC.

Trent Nebeker, the Vice President of Sales, Service and Marketing for CSLFC came to the corporation from the Bank of America. Nebeker was the CSLFC officer who was the most knowledgeable of the operations at UES, the servicer handling the FITCO originated loans. Problems quickly developed with the increased loan volume that FITCO originated, CSLFC bought and UES serviced.

In 1987, UES experienced "computer conversion problems" that prevented the servicer from adding incoming accounts to its system. Nebeker told the staff that UES was servicing approximately 600,000 loans, while at the same time, FITCO and CSLFC simultaneously continued to increase their great volume of business. Sources have said that due to the computer problems and other factors that will be discussed in greater detail in later testimony, the new loans were literally thrown into boxes, allowed to accumulate, setting UES woefully behind in its due diligence work. This then created a situation threatening the guarantee status of the loans. Eventually these problems ballooned to such an extent that a great volume of UES serviced loans lost their guarantee. The Department of Education pulled its guarantee of the loans mishandled by UES in March 1989, an event that rippled throughout the student loan community and affected a great number of players - literally around the world.

Nebeker said that he was never aware of the backlog of work at UES; and former UES workers confirmed that UES hid the obvious indicators from CSLFC. We learned that when UES servicing staff became aware that Nebeker was coming to observe operations at the service center, staffers would go so far as to shove bundles of paperwork into desk drawers. This gave the appearance that UES was adequately handling its increased work load. Unfortunately, paper that was crammed into desk drawers, often never came back out.

At the point that UES servicing began to fall apart, CSLFC owned over a $1 billion student loan portfolio that was nearly equally guaranteed by CSAC and HEAF. The guarantors no longer honored the loans spoiled by UES' lack of due diligence. CSLFC was forced to evaluate its losses and thus made the choice to stop buying loans, perhaps "driving the nail in FITCO's coffin." The Letter of Credit banks, many of which were foreign, backing the student loans because of their federal guarantee, now feared that some of what was held out as "government guaranteed" was worthless paper.

Our review of this entire incident quickly found that responsibility remains a key issue that has not been settled and is being heavily litigated. The principal players continue to point fingers at each other, and eventually, it seems, the courts will decide.

BANK OF AMERICA AS TRUSTEE

The Bank of America, as trustee of CSLFC, is also facing criticism for its role in the fiasco. Because CSLFC was not an eligible lender of student loans, it had to turn elsewhere for a lender identification number to conduct its business. The Bank of America agreed to allow CSLFC, as its trustor, to use its lender number in the buying, selling and holding of student loans. Loans contained in the CSLFC portfolio are held in title by the Bank of America on behalf of the corporation.

The bank contends that as trustee, it did have some administrative processing duties over the indentures but no oversight responsibilities of a managerial type. The bank held certificates for loans and any other records that CSLFC submitted to it. It also assumed duties relating to the accounting of the monies of the bond indentures.

Also, according to Bank of America officials, the bank had no contract with UES for servicing; rather there was a trust department agreement with the servicer. Bank of America officials told the Subcommittee staff that at one point, the bank questioned whether UES could handle the increased loan servicing volume and the new due diligence requirements resulting from the 1986 amendments to the Higher Education Act, and were assured by UES that it could handle the changes in loan servicing requirements. Bank officials argue that they had no reason to suspect problems in the CSLFC loans serviced by UES because auditors hired by CSLFC did not detect them. The bank maintains it had no knowledge of CSLFC/UES problems until 1988 when the Department of Education Inspector General's office and HEAF discovered them.

After learning of the servicing problems at UES, the Bank of America attempted to determine the extent of the damage to the CSLFC portfolio and to salvage the massive portfolio. By November 1988, UES was replaced as the servicer by Costa Mesa Service Center (CMSC), a subsidiary of the Academic Financial Services Association (AFSA). Additionally, Bank of America bought the hardware and software from UES servicing so that the loans in the portfolio could be kept "alive."

In determining the extent of damage done to the portfolio, Bank of America found, and reported to the Department of Education, another serious UES servicing problem. Discovered were two computer programs, FIX and COMFIX, that were apparently created at UES to falsify due diligence activities on a number of student loans in 1987. Clearly those loans affected would no longer maintain their guarantee status and thus are currently being repurchased from the agencies having paid claims on them.

Bank of America's problematic trustee status related to servicing of CSLFC loans is not limited to UES alone. The staff has learned that a relatively small portion of CSLFC's portfolio, $135 million in loans, was serviced by Mitchell Sweet and Associates (MSA), a privately owned student financial aid consultant and loan servicer. In July and August of 1988 a program review of MSA was conducted jointly by the Inspector General of the Department of Education and HEAF. It was concluded then, and reported again in a December 1989 IG audit of loan servicing procedures at MSA, that the servicer had "engaged in the systematic falsification of loan collection activities" from May through July 1988. This is offered as an exhibit. The review further states that employees entered fictitious phone calls and backdated missing letters in system records to conceal that required due diligence steps had not been performed. This case was referred to the U.S. Attorney's office by the Department of Education Inspector General's office but according to the IG's office, criminal prosecution was declined because the prosecutors felt it was primarily an administrative problem.

The staff has been told that Bank of America, in protecting its interests, also looked into the scope of the Mitchell Sweet servicing problems. It, too, found a number of due diligence telephone calls had been backdated. We were told, however, that the bank also chose to view this problem as administrative rather than criminal in nature. Mitchell Sweet and Associates continues to service loans for CSLFC and other markets today.

PORTFOLIO PROBLEMS

The CSLFC portfolio has several readily identifiable problems that should be mentioned. When CSLFC purchased the majority of its student loans from First Independent Trust, it inherited a default problem that has become almost synonymous with a portfolio made of a large amount of proprietary school paper. It has been well documented that the default rate among students attending trade schools is nearly five times that of students attending four-year institutions(33% vs 7%). Here it becomes obvious that CSLFC was purchasing, for the most part, problematic loans.

FITCO's multiple disbursement practices also presented a problem for CSLFC. FITCO often disbursed its loans in installments and sold the installments to the secondary market. This procedure was agreed to by CSLFC and FITCO, yet CLSFC failed to maintain the separately disbursed loans as single loans. CSLFC placed the disbursements into separate bond offerings. This creates servicing problems down the road if the disbursements are not consolidated into the single loan they represent. For instance, a student may receive multiple notices asking for payment of a single loan. If the student pays one notice thinking that he or she is in compliance with the loan agreement, it may incorrectly appear that he or she is in default regarding the separate disbursements that are not being paid. Considering the volume of loans in the CSLFC portfolio as well as the inability of UES to handle the workload, it would be beyond reason to expect that all the disbursements making up singular loans would have been consolidated.

Finally, it was mentioned earlier that FITCO originated and sold its loans at a very rapid rate. This rate did not allow time for students to cancel their loans before the loans were sold to CSLFC. Also, a great number of refunds that should have been forwarded to CSLFC or UES by FITCO were not. By not reaching the secondary market, these cancellations and refunds caused considerable confusion and undue expense. The Department of Education undoubtedly paid excessive interest and special allowance to CSLFC over the years.

UNITED EDUCATION AND SOFTWARE (UES)

United Education and Software ("UES") was started by Aaron Cohen around 1980 as a company which owned and operated a string of technical and proprietary schools. In approximately mid-1982, UES purchased Tuition Systems Inc., a Florida company which serviced National Direct Student Loans. It was through this acquisition that UES gained entree into the servicing aspect of the Guaranteed Student Loan program.

UES began servicing the loans sometime in the late fall of 1982. At first, UES's servicing operation was quite modest.

Operating out of a converted warehouse with about 8,000 square feet of space, UES was servicing only $2 million worth of loans by March 1983. Just five years later, however, UES was operating out of a 42,000 square foot facility and was servicing $1.2 billion worth of student loans.

One would assume that such phenomenal growth in such a short period of time would be the mark of a superbly managed company, a company on the cutting edge in terms of innovation and technlogy in its field. In April 1988, UES stock sold at $16.25 per share. In reality, however, the staff's investigation has revealed that UES was a company plagued by incompetence, inefficiency, and a general inability to keep pace with its own growth. In March 1989, the company's stock sold at $1.35 per share.

More significantly, however, UES was also a company in which improper, if not illegal, steps were taken to cover up these problems. In fact, by the summer of 1988 UES's operation had deteriorated to such a point that a program review of UES jointly conducted by the Department of Education, the California Student Aid Commission, and the Higher Education Assistance Foundation concluded as follows:

> UES has demonstrated no ability whatsoever to service loans in accordance with Federal regulations. UES's performance has caused unmeasurable hardship to hundreds of thousands of borrowers and has cost guarantors, the United States Government, and taxpayers millions of dollars. The borrowers being serviced by UES deserve a first chance to repay their student loans. UES does not deserve a second chance to service these loans.

Before we detail how UES reached the state described above, let us first briefly outline the role that a servicing company such as UES plays within the context of the student loan program. In the most succinct of terms, the servicing company is responsible for managing a loan on behalf of the holder of the loan. The company must keep track of the status of the borrower. While the borrower is in school, he is not required to make any payments; rather the federal government makes special interest and allowance payments.

Once the borrower finishes school, a short grace period ensues. Again the borrower is not required to make payments during this grace period. Upon expiration of the grace period, however, repayment does commence. The servicing company sends a coupon booklet to the borrower, who then sends monthly payments to the servicer for crediting to his account.

If a borrower fails to make payments, the servicing company is obligated to perform what is known a "due diligence." At certain specified times over the course of a 180 day interval, the servicing company must attempt to contact the borrower by letters and phone calls in order to secure payment. If normal payment on the loan has not been secured after the 180 day period, the loan is considered as defaulted. The servicing company may then file, within an additional 90 day, a claim with the guarantee agency guaranteeing the loan for full repayment of the loan. If the proper steps have been taken by the servicing company, the guarantee agency will pay the default claim. The guarantee agency in turn will then submit a claim for a reinsurance payment to the federal government.

UES performed, or at least was required to perform, these functions from 1982 until 1988. For the most part, the loans which UES serviced during this time came from one source -- The California Student Loan Finance Corporation ("CSLFC"). It has been estimated by UES management that close to 99% of the loan serviced by UES came from CSLFC. Conversely, the loans serviced by UES for CSLFC represented approximately 90% of the loans held by CSLFC. Indeed, it was the CSLFC - UES relationship which propelled the tremendous growth in the size of UES's operations.

When CSLFC first contracted with UES in 1982 to service its loans, CSLFC was a relatively new player in the secondary market. By 1988, however, CSLFC had raised over $2 billion for the purchase of student loans and had become the operator of the country's second largest secondary market for student loans.

It is clear from the staff's investigation that as the size and number of portfolios serviced by UES grew, the company became less and less able to perform the required functions of a servicer. What had started out, in the words of some employees, as a "mom and pop operation", became in a short period of time one of the larger servicers in the country. Unfortunately, it did so without the benefit of an adequately sized staff, without the benefit of an adequately trained staff, without the benefit of adequate computer and other support systems, and without the benefit of adequate internal controls or procedures.

All of this was a recipe for disaster. As a result, UES failed to perform many of the required functions of a servicer. In some instances, it appears steps were taken to cover up the fact that these functions had not been performed; indeed, it also appears that in some instances UES falsified records and documents to create the impression that required steps had been taken when, in fact, they had never been done.

UES EMPLOYEES

Almost every former UES employee the staff interviewed states that the UES staff was inadequate to perform the tasks assigned to it. When UES first began servicing loans, its staff numbered approximately 25 people. By 1985, the total number of employees had grown to 65, and by 1988 the number stood at approximately 150. Although this represents a six-fold increase in staff over six years, it should be remembered that in this same period of time the dollar value of the loans being serviced by UES had increased six hundred-fold. Gretchen Staff, Former Vice President for the student loan servicing division stated that she informed UES President Aaron Cohen on a number of occasions of the need for more employees. According to Ms. Staff, her efforts were to little or no avail.

An inadequately sized staff with an ever-increasing portfolio of loans led to tremendous backlogs at UES. One employee told us that by 1986 UES had a backlog of 6,000 pieces of mail from borrowers which had not been processed. A former manager in the Collections Department told us that when he took over the department in 1987, he found his office full of boxes of loans which had never been worked on or filed. According to this individual, some of these loans were up to two years old.

A former manager in the Skip Tracing Department told us that when he took over that department he encountered a two year backlog of returned mail which had never been processed. He estimated the number of pieces of unprocessed returned mail at approximately 14,000. Another employee was assigned in 1987 to a unit which handled bankruptcies, deaths and disabilities. This employee stated that when she was assigned to this unit she discovered a pile of paperwork, representing some two to three years worth of accounts that had been left lying around without anyone to work on them. After this employee left that particular unit, no one was assigned to take her place.

We were also told that UES had only one employee assigned to the task of processing accounts whose claims had been rejected by the guarantee agencies, a process known as the "cure" process. One former employee who worked in that position for a short time stated that UES was receiving back 1000 claims per month which needed to be cured. By 1988, we were told, UES had 20,000 accounts which needed to be cured and one employee assigned to the task.

In addition to an inadequately sized staff, UES's staff was also inadequately trained. Indeed, many former employees referred to UES's training as "laughable." In fact, UES had no formal training program until 1987. New employees, the vast majority of whom had no experience either in servicing student loans or with the student loan program in general, received their training by sitting for a few days with an experienced employee and observing what he or she did. Instruction in the requirements of the student loan program was minimal to non-existent. The lack of familiarity with the requirements of the student loan program was a major source of problems at UES. One example involved a women who was hired as a collections supervisor. Although this women had experience in commercial loan collections, she had no experience in student loan collections, where the philosophy toward the borrower, and the actions allowed to be taken against the borrower are vastly different from the commercial area. In one incident a borrower who was permanently disabled and on a fixed income had worked out an agreement with a customer service representative for a forbearance on a repayment in the amount of $200. When this supervisor found out about the arrangement, she personally called the borrower, told him that if he did not make repayment his loan would be defaulted, and that if it was necessary he would have to go out and obtain a bank loan to pay off his student loan. After this call, the borrower in fact took out a bank loan to pay off his student loan.

In another incident, an individual with no student loan experience was made the accounts receivable supervisor. When an experienced employee approached this supervisor at one time to inquire about adjustments to government interest billings for accounts which had been refunded for cures, the supervisor told the employee that he had no idea that such adjustments needed to be made. In essence, UES was billing the Federal Government for interest payments on accounts for which it was not entitled to collect such interest, at least in part because the responsible employees had no knowledge as to when such billings were and were not allowed.

Several former employees told us not only that the UES staff was by and large incompetent, by that in addition, it almost seemed that competent employees were forced out. UES's turnover rate, we were told by almost all employees, was very high.

In addition to the incidents cited above, the inadequacies of the UES staff led to a host of other problems. Important documentation such as original promissory notes and loan applications were misfiled or lost. This would affect the ability of UES to submit a claim to the guarantee agency should these accounts default. Due diligence work was not done on a timely basis or sometimes was not done at all. Again this would affect UES's ability ultimately to submit a claim should these accounts default.

Borrower payments were not processed in a timely manner, causing borrowers in many instances to be charged interest for periods of time during which their payment was actually in UES's possession. Borrower requests for deferments and forbearances also were not processed in a timely manner, sometimes leading to accounts being defaulted for which a deferment or forbearance could have been granted. Finally, skip tracing, which is the process of trying to locate a borrower for whom the servicer has an incorrect address, was performed in only the most cursory of fashions. The backlog of returned mail was so great that the only steps the skip tracing department were able to take in most instances consisted of entering the borrower on the computer system as a "skip" and, if the computer system listed a reference for the borrower (which in many instances it did not), sending a form letter to the reference asking for information. Further steps were rarely taken and, we were told, many accounts were defaulted without any meaningful attempt being made to locate the borrower.

SYSTEMS

The problems caused by the inadequacies of UES's staff were compounded by the inadequacies of its computer and other automated systems.

When UES first started servicing guaranteed student loans, it was using a converted National Direct Student Loan software program. UES's computer operations were very simple at the outset; indeed rather than having a full time computer staff for the first few years, UES used an employee from the technical school side of its operations to come in from time to time to work on its software. A computer staff for the loan servicing operations apparently was not hired until 1984 or 1985.

As the volume of loans being serviced by UES skyrocketed the computer system became less and less suitable. During its six years of operation, UES undertook three conversions of its computer systems. The last one, which was undertaken in 1987 was described by most employees as a "disaster." The consensus seemed to be that the software installed during this conversion was totally unsuited for the tasks which needed to be accomplished. A former computer operations supervisor, who had extensive experience working with larger computer systems, called the software "garbage."

Common complaints regarding the computer system by former employees included the slow response time of the system and the frequent down-time which was encountered. A number of employees told us that the computer system never really reflected what had happened with a borrower's account, but merely what was supposed to happen. In addition, we were told that the system was just incapable of performing certain tasks, forcing employees to perform these tasks manually.

Two examples will illustrate the types of problems caused by the computer system's failings. A former employee who had worked in the claims department told us that she received a call from a guarantee agency in August 1987, informing her that very few pre-claim notices had been received by the guarantee agency in the previous few months. When the employee checked with the data processing department, which was responsible for transmitting these notices, she was informed that the computer program which performed this task was not working, and indeed had not been working for the past six months. As a result, pre-claim notices, which are required to have been transmitted before a defaulted account can be claimed, had simply not been sent.

Another employee told us that the computer system did not have a way in which deferments could be entered onto the system. As a result, employees dealt with deferments by merely changing the borrower's exit date to reflect the last date of the deferment. This, however, would affect the ensuing grace period which the student would receive. The grace period following a deferment is six months. The grace period following a borrower's departure from school, otherwise known as his exit date, is nine months. During this grace period the federal government continues to make special interest and allowance payments. The effect, therefore, of UES's attempts to get around its system's shortcomings was to charge the government for three extra months of interest for which it should not have been paying.

PROBLEMS LEAD TO SHORT-CUTS, FALSIFICATIONS

As the problems with UES's servicing operations mounted, the reaction among some supervisors seemed to be to attempt to take whatever shortcuts were necessary, including the falsification of records, to get the accounts out the door, rather than stopping to deal with the problems at hand.

Collections employees were plagued by a constant backlog of accounts needing collection, an antiquated manual dialing system, and later, an automated dialing system which was not compatible with the overall computer system. In the midst of all this we were told that one collection supervisor continued to impose unrealistically high quotas of calls to be made by each collections employee.

A number of former employees told us that in order to speed things up they were instructed by the supervisor to allow the phone to ring only twice and then hang up and list the call as a "no answer." At other times, these employees said, they were told to merely insert " call - no answer" entries into the computer without even making the calls. These employees, who said they refused to do this, stated that they observed at least one employee in fact inserting such false entries.

Falsifications with respect to collection activity apparently went beyond the mere padding of telephone calls made. One former customer service employee told us of an incident in 1986 in which she received a call from a borrower inquiring as to the status of his loan. When the employee pulled up the account's history she discovered that the account had improperly been in a grace period for two years. She happened to relate this to another employee who went off and returned ten minutes later with a computer printout of that borrower's account which had plugged in all the required due diligence steps which should have been taken over that period. When the first employee complained about the obvious falsification, the second employee stated that she had often done this type activity for accounts which needed to be claimed.

Claims employees also told us of shortcuts taken to deal with the problems in the department. Working under strict time deadlines, claims employees were responsible for ensuring that claim packets contained complete documentation and that all required due diligence steps had been performed. If a claim packet was lacking in any regard, it should be sent to the cures department rather than to the guarantee agency for claim.

In many instances claims employees told us that they received claim packets just before the deadlines for submitting the claims, and that these packets often were lacking either important documents, proper due diligence steps, or both. We were told time and again by numerous employees that they were instructed by UES's Operations Manager to submit these packets for claim despite missing documentation or lack of proper due diligence. These employees stated that the attitude expressed by the manager was that perhaps some of the claims would slip though and be paid by the guarantee agency, and that, in the worst case, if the claims were rejected, UES would at least have bought itself additional time to attempt to cure the account. A rejected claim was seen as preferable to missing a deadline for filing a claim.

In instances where documentation such as original promissory notes or loan applications were missing from the claim packets employees were instructed to sign affidavits stating that these documents had existed but were temporarily missing. One employee told us that these affidavits were routinely signed without any attempt being made to verify whether the original documents had in fact ever been in UES's possession.

Similar actions were taken with respect to final demand letters to the borrower which are required to be sent prior to submitting a claim. In instances where the claim packets did not contain copies of these letters, claims employees told us they were instructed to manually type out, and later to computer generate another copy of the letter without bothering to ascertain whether the original letter had in fact ever been sent. In many instances we were told that these letters were generated for insertion with full knowledge that the originals had in fact not be sent.

The pressure to meet deadlines for submission of claims apparently led to other types of doctoring of the claims packets as well. Employees told us that they were at times directed by the Operations Manager to backdate claims packets so that it would appear that they were sent out within the appropriate deadline. This effort went so far, we were told, as to involve not only the manual backdating of documents, but also the backdating of UES's postage meter machine so that the cancellation mark on the envelopes in which the claims packets were sent would reflect a date prior to an already missed deadline.

Backdating at UES apparently involved more that just mail. After UES's servicing operations were liquidated in 1988, employees of Bank of America discovered two computer programs developed by UES, FIX and COMFIX, that had apparently been designed to insert after the fact false entries of due diligence activities into borrower's collection histories. Testing of this program by Bank of America confirmed that these programs had in fact been run at least once in 1987.

Indeed, the use of such programs would explain a number of suspicious due diligence entries which were questioned during audits of UES in 1988. These entries included collections calls made by employees who were not even in the collections department, calls made by employees who no longer worked at UES, calls made at all hours of the day and night, and calls for which the exact same result was listed time after time. A check of telephone company records failed to substantiate these calls, which numbered in the hundreds.

It appears that UES engaged in widespread activity to mask its inability to properly service its loan portfolios, activity which in some instances involved outright falsifications of documentation. And yet, no one but the line level employees admitted to the staff that they were aware of the actions that were being taken. UES's President, Aaron Cohen, states that he only visited the servicing operations once a year and was not aware of any major problems. UES's Vice President, Gretchen Staff, who was in charge of the servicing operations, says that she was aware of problems with the computer system and problems with backlogs in various departments but that she never knew of any falsifications of records. UES's Operations Manager, Leita Elliot, whom almost all employees stated was the real person overseeing day-to-day operations, told us that she did not recall directing any employees to falsify or take any other improper actions with respect to claims or other matters.

The level of knowledge, or at least admitted knowledge, between Grechen Staff and Leita Elliot, however, seems strangely incongruent. As Operations Manager, Leita Elliot was Gretchen Staff's "right-hand person." Elliot claims that she kept Staff fully informed of what was going on with UES's operations.

Against this background, two incidents strike us as rather strange. The first involves a former employee in the cures department who apparently negotiated some borrowers' checks for her own use. Several employees had informed us of this incident, and when we questioned Leita Elliot about it, she told us as well that she had become aware at some point of at least one check which had been negotiated by this employee. When we questioned Gretchen Staff about this incident, however, she stated that she had never heard of anything like that, and that such a thing couldn't possibly have happened.

The second incident related to certain daily logs which were prepared in late 1987 and early 1988. These logs contained statistics on number of accounts in cure status, number in repayment, number of calls which had been made and other information of a similar nature. Several employees told us that two sets of such logs were maintained, one of which was a falsified set. According to these employees, the falsified set was given to Rich Loritsch, an individual who had been brought in during that time frame to oversee UES's servicing operations. These employees stated that Leita Elliot and Gretchen Staff both participated in preparing these false reports.

When we questioned Gretchen Staff about this incident she did admit that Loritsch was given a different set of statistics on cures, although she said she wouldn't call it a falsified set. She stated that this was done because Loritsch was reviewed as CSLFC's man and everyone at UES was irritated by his presence. She stated that Leita Elliot was fully aware of the two sets of statistics. When we questioned Leita Elliot about this matter, however, she stated she had no memory of any preparation of falsified statistics for Loritsch.

AUDITS

Although, according to many of the employees with whom we spoke, UES experienced major problems for a number of years, these problems never seemed to have been detected by various outside auditors who examined UES's operations over the years. If these problems were detected by auditors, they do not seem to have raised any major concerns among the auditors as to UES's ability to continue to perform as a servicing company.

UES was audited a number of times by different groups during the course of its existence. Auditors working for CSLFC reviewed UES's operations on a yearly basis. Year after year these reviews disclosed nothing to indicate that UES's servicing system and procedures were not in accordance with due diligence regulations. Interestingly enough, this conclusion was included even in a 1985 review in which it was stated that "the servicer no longer keeps any record of the date on which student loan repayments are received."

Reviews were also conducted by the California Student Aid Commission biennially. Although these reviews cited more problems than the CSLFC reviews, they still did not raise any questions as to UES's overall ability to perform.

Indeed it was not until an audit jointly conducted in 1988 by the Department of Education, the California Student Aid Commission and the Higher Education Assistance Foundation that the question of UES's ability to perform was first raised.

Although we cannot offer any definitive reasons for the differences among these audits, we do note that we were told by several former UES employees that UES generally knew in advance the specific student files which were to be reviewed during an audit. According to these employees the week or so before an audit was a frantic time in which files were pulled and corrections were made or necessary work performed to get those files in presentable form. Some employees even said that information was falsified on files in order to pass muster with auditors.

Almost every employee with whom we spoke also said that a general house-cleaning was done prior to an audit -- boxes of documents which had been piling up previously were hidden away and desks were cleared off. Employees also said that they were told that if an auditor asked them any questions they were not to answer them, but rather to refer them to a supervisor.

These activities probably helped UES get through its audits prior to 1988. What differentiated the 1988 audit, however, was that UES was not told of the files to be reviewed until the audit team arrived on site.

In June 1988, HEAF stopped paying all claims on UES serviced loans. CSAC followed suit the following month.

CONCLUSION

Mr. Chairman, this concludes our testimony regarding this complex incident. The performance by program participants and the Department of Education in this and other matters has not been encouraging. Over the next several months, the staff will be working on a number of recommendations. We will be happy to answer any questions you may have for us at this time.

#

(d) Eligible lender

(1) In general

Except as provided in paragraphs (2) through (5), the term "eligible lender" means—

(A) a National or State chartered bank, a mutual savings bank, a savings and loan association, a stock savings bank, a trust company, or a credit union which—

(i) is subject to examination and supervision by an agency of the United States or of the State in which its principal place of operation is established, and

(ii) does not have as its primary consumer credit function the making or holding of loans made to students under this part unless (I) it is a bank which is wholly owned by a State, (II) it is a single wholly owned subsidiary of a bank holding company which does not have as its primary consumer credit function the making or holding of loans made to students under this part, or (III) it is a trust company which makes student loans as a trustee pursuant to an express trust and which operated as a lender under this part prior to January 1, 1981;

(B) a pension fund as defined in the Employee Retirement Income Security Act [29 U.S.C.A. § 1001 et seq.];

(C) an insurance company which is subject to examination and supervision by an agency of the United States or a State;

(D) in any State, a single agency of the State or a single nonprofit private agency designated by the State;

(E) an eligible institution which meets the requirements of paragraphs (2) through (5) of this subsection;

(F) for purposes only of purchasing and holding loans made by other lenders under this part, the Student Loan Marketing Association or an agency of any State functioning as a secondary market;

(G) for purposes of making loans under sections 1078-1(d), 1078-2(d), 1078-3, and 1087-2(q) of this title, the Student Loan Marketing Association;

(H) for purposes of making loans under sections 1078(h) and 1078(j) of this title, a guaranty agency;

(I) a Rural Rehabilitation Corporation, or its successor agency, which has received Federal funds under Public Law 499, Eighty-first Congress (64 Stat. 98 (1950)); and

(J) for purpose of making loans under section 1078-3 of this title, any nonprofit private agency functioning in any State as a secondary market.

GUARANTEED STUDENT LOAN PROGRAMS · 100 LEADING ORIGINATING LENDERS -- FY88

	LENDER NAME	FY88 ORIGINATIONS ($)	CITY	ST.	(1)
1.	CITIBANK, NA (NEW YORK)	570.8	ROCHESTER	NY	1
2.	BANK OF HORTON	399.3	HORTON	KS	1
3.	FIRST INDEPENDENT TRUST CO.	378.3	SACRAMENTO	CA	3
4.	CHASE MANHATTAN BK, NA (NEW YORK)	300.8	NEW HYDE PARK	NY	3
5.	CHEMICAL BANK (NEW YORK)	188.0	JERICHO	NY	5
6.	PENNBANK	164.8	MEADVILLE	PA	1
7.	BANK OF AMERICA, NA	163.2	LOS ANGELES	CA	1
8.	TRANSWORLD INSURANCE COMPANY	162.8	SACRAMENTO	CA	1
9.	NORWEST BANK OF SOUTH DAKOTA, NA	160.5	SIOUX FALLS	SD	7
10.	MARINE MIDLAND BK, NA (DELAWARE)	151.5	WILMINGTON	DE	6
11.	FIRST AMERICA SAVINGS BANK, FSB	144.7	LONGMONT	CO	1
12.	UNIVERSITY SAVINGS ASSOCIATION	136.3	AUSTIN	TX	1
13.	MERITOR SAVINGS BANK	136.1	PLYMOUTH MEETING	PA	4
14.	BOATMEN'S BANK GROUP (MISSOURI)	136.0	ST. LOUIS	MO	23
15.	FIRST AMERICAN SAVINGS	135.4	TUCSON	AZ	1
16.	FLORIDA FEDERAL SAVINGS BANK	128.4	ST. PETERSBURG	FL	1
17.	GREAT WESTERN SAVINGS	110.8	NORTHRIDGE	CA	1
18.	BANK IV, NA	90.1	WICHITA	KS	5
19.	VALLEY NATIONAL BANK	85.7	PHOENIX	AZ	1
20.	SIGNET BANK (MARYLAND)	83.3	BALTIMORE	MD	1
21.	MERCHANTS NATIONAL BANK	78.7	TOPEKA	KS	1
22.	GLENDALE FEDERAL S & L ASSO.	77.7	GLENDALE	CA	1
23.	MARINE MIDLAND BK, NA (NEW YORK)	76.3	BUFFALO	NY	1
24.	BANK ONE, NA (OHIO)	72.8	COLUMBUS	OH	21
25.	UNION BANK & TRUST COMPANY	70.1	LINCOLN	NE	3
26.	TWIN CITY FEDERAL S & L ASSO.	64.7	MINNEAPOLIS	MN	1
27.	PITTSBURGH NATIONAL BANK	62.8	PITTSBURGH	PA	1
28.	COLLEGE FOUNDATION	60.4	RALEIGH	NC	1
29.	CENTRUST SAVINGS BANK	58.3	MIAMI BEACH	FL	1
30.	MANUFACTURERS HANOVER TRUST CO.	58.0	HICKSVILLE	NY	1
31.	FIRST BANK, NA (WISCONSIN)	57.2	MILWAUKEE	WI	6
32.	INDIANA NATIONAL BANK	56.5	INDIANAPOLIS	IN	1
33.	FIRST INTERSTATE BANK OF ARIZONA	[illegible]	PHOENIX	AZ	1
34.	WELLS FARGO BANK, NA	[illegible]	WALNUT CREEK	CA	1
35.	MELLON BANK, NA (PENNSYLVANIA)	49.4	PITTSBURGH	PA	6
36.	GLENDALE FEDERAL S & L ASSO.	48.4	FT. LAUDERDALE	FL	1
37.	BAYBANK NORFOLK COUNTY TRUST CO.	48.5	DEDHAM	MA	1
38.	ONE VALLEY BANK, NA	46.9	CHARLESTON	WV	8
39.	HAWKEYE BANK & TRUST COMPANY	46.6	DES MOINES	IA	7
40.	HOWARD SAVINGS BANK	46.1	LIVINGSTON	NJ	1
41.	MERABANK	44.5	PHOENIX	AZ	1
42.	ONONDAGA SAVINGS BANK	40.4	SYRACUSE	NY	1
43.	MBANK	40.4	FT. WORTH	TX	7
44.	INDEPENDENCE FEDERAL SAVINGS BANK	39.9	WASHINGTON, D.C.	DC	1
45.	WINDSOR SAVINGS ASSOCIATION	37.9	AUSTIN	TX	1
46.	NEBRASKA HIGHER ED. LOAN PROGRAM	37.7	LINCOLN	NE	1
47.	CITIZENS & SOUTHERN NATIONAL BANK	37.6	COLUMBIA	SC	7
48.	U.S. BANK OF WASHINGTON, NA	36.9	SPOKANE	WA	1
49.	AMERITRUST COMPANY	36.1	CLEVELAND	OH	2
50.	COMMERCE BANK	36.0	ST. LOUIS	MO	1
51.	MID-CONTINENT FEDERAL S & L ASSO.	35.4	EL DORADO	KS	1
52.	UNITED BANK GROUP (COLORADO)	31.9	DENVER	CO	8
53.	BANK ONE, NA (INDIANA)	31.8	INDIANAPOLIS	IN	11
54.	CHASE LINCOLN FIRST BANK, NA	30.9	ROCHESTER	NY	2
55.	CONTINENTAL FEDERAL S & L ASSO.	30.4	OKLAHOMA CITY	OK	3
56.	BANK OF NORTH DAKOTA	29.8	BISMARCK	ND	1
57.	NORTH CAROLINA NAT'L BANK (TEXAS)	29.5	DALLAS	TX	5
58.	NATIONAL CITY BANK	29.1	CLEVELAND	OH	6
59.	CRESTAR BANK	28.1	RICHMOND	VA	1
60.	EMPIRE OF AMERICA, FSB	27.7	WILLIAMSVILLE	NY	4
61.	WESTERN LOAN MARKETING ASSO.	26.3	SCOTTSDALE	AZ	2
62.	MERCHANTS NAT'L BANK & TRUST CO.	26.3	INDIANAPOLIS	IN	1
63.	FIRST WISCONSIN BANK GROUP	25.6	MILWAUKEE	WI	20
64.	BANCO POPULAR DE PUERTO RICO	25.5	SAN JUAN	PR	1
65.	SOUTHSIDE STATE BANK	25.0	TYLER	TX	1
66.	U.S. BANK OF OREGON	25.0	PORTLAND	OR	1
67.	FIDELITY BANK	24.8	UPPER DARBY	PA	1
68.	CARTERET SAVINGS BANK	24.5	PARSIPPANY	NJ	1
69.	FIRST TENNESSEE BANK	24.2	MARYVILLE	TN	1
70.	MARYLAND NATIONAL BANK	24.1	BALTIMORE	MD	1
71.	FIRST INTERSTATE BANK OF OREGON	23.8	PORTLAND	OR	1
72.	AETNA BANK	23.1	CHICAGO	IL	1
73.	FIRST INTERSTATE BK OF CALIFORNIA	22.8	POMONA	CA	1
74.	SIMMONS FIRST NATIONAL BANK	22.8	PINE BLUFF	AR	1
75.	KEY BANK, NA	22.2	ALBANY	NY	3
76.	CITICORP SAVINGS OF ILLINOIS	21.7	CHICAGO	IL	1
77.	SECURITY PACIFIC CREDIT CORP.	21.7	SANTA ANA	CA	1
78.	FIRST BANK, NA (MINNESOTA)	20.9	ST. PAUL	MN	1
79.	FIRST NATIONWIDE BANK	20.7	CLAYTON	MO	2
80.	FIRST OF AMERICA BK, NA (MICH.)	20.5	KALAMAZOO	MI	31
81.	ZIONS FIRST NATIONAL BANK	19.8	SALT LAKE CITY	UT	1
82.	CAPITOL FEDERAL S & L ASSOCIATION	19.6	TOPEKA	KS	1
83.	FIRST BANK OF GREAT FALLS	19.6	GREAT FALLS	MT	1
84.	FIRST FINANCIAL BANK, FSB	19.1	STEVENS POINT	WI	2
85.	SOUTHTRUST BANK, NA	18.7	BIRMINGHAM	AL	6
86.	VIRGINIA EDUCATION LOAN AUTHORITY	17.9	RICHMOND	VA	1
87.	SPRINGFIELD INST. FOR SAVINGS	17.8	SPRINGFIELD	MA	1
88.	AMERICAN BANK OF NORTHWEST MO.	17.6	MARYVILLE	MO	1
89.	BANK OF NEW ENGLAND	17.4	WORCESTER	MA	4
90.	FIRST CITY NATIONAL BANK	17.4	HOUSTON	TX	1
91.	SOVRAN BANK (TENNESSEE)	17.3	NASHVILLE	TN	2
92.	SHAWMUT BANK, NA	17.2	CAMBRIDGE	MA	11
93.	FIRST PENNSYLVANIA BANK, NA	17.0	PHILADELPHIA	PA	1
94.	MERIDIAN BANK	17.0	READING	PA	1
95.	FIFTH THIRD BANK	16.9	CINCINNATI	OH	4
96.	TEXAS COMMERCE BANK, NA	16.8	HOUSTON	TX	6
97.	FIRST FIDELITY BANK, NA	16.6	NEWARK	NJ	3
98.	SEAFIRST	16.5	SEATTLE	WA	1
99.	AMSOUTH BANK, NA	16.5	BIRMINGHAM	AL	1
100.	NORTH SHORE S & L ASSOCIATION	16.5	BROOKFIELD	WI	2

(1) COUNT OF LENDER IDENTIFICATION NUMBERS COMBINED.

NOTES: (1) $ IN MILLIONS.
(2) INCLUDES STAFFORD, PLUS & SLS LOANS. EXCLUDES CONSOLIDATION LOANS.
(3) SOURCE: CALL REPORT

TOP 100 : 6,583.3 : (65% OF ALL ORIGINATIONS)
TOP 75 : 6,124.5 : (60% OF ALL ORIGINATIONS)
TOP 50 : 5,454.1 : (53% OF ALL ORIGINATIONS)
TOP 25 : 4,249.5 : (42% OF ALL ORIGINATIONS)

APPENDIX "B"

TOP 100 GSLP, STAFFORD, SLS, AND PLUS LOAN ORIGINATORS FOR FY 1989

RANK GSLP	LENDER NAME	CITY	ST	FY 1989 ORIGINATIONS ($ IN MILLIONS) (SEQUENCED ON TOTAL GSLP FROM HIGH TO LOW) TOTAL GSLP	STAFFORD	SLS	PLUS	RANKINGS STAF	SLS	PLUS
1	CITIBANK, NA	ROCHESTER	NY	601.1	409.8	157.9	33.4	1	1	2
2	BANK OF AMERICA, NT & SA	PASADENA	CA	336.6	224.5	97.6	14.5	2	2	4
3	CHASE MANHATTAN BANK, NA	NEW HYDE PARK	NY	264.5	192.4	40.6	31.6	3	11	3
4	BANK OF HORTON	HORTON	KS	263.0	177.9	78.2	6.9	4	3	17
5	MARINE MIDLAND BANK, NA	BUFFALO	NY	232.0	173.8	45.3	13.0	5	9	6
6	CHEMICAL BANK	JERICHO	NY	214.8	145.5	63.1	6.3	7	4	19
7	MELLON BANK	PITTSBURGH	PA	197.8	149.0	46.4	2.4	6	6	58
8	MERITOR SAVINGS BANK, FSB	PLYMOUTH MEETING	PA	191.7	133.8	44.0	13.9	8	10	5
9	NORWEST BANK SOUTH DAKOTA, NA	SIOUX FALLS	SD	186.3	132.0	46.7	7.5	9	7	11
10	BOATMEN'S BANK GROUP	ST. LOUIS	MO	182.9	124.2	48.3	10.4	10	5	9
11	FIRST AMERICA SAVINGS BANK, FSB	LONGMONT	CO	158.7	98.8	46.9	13.0	11	8	7
12	INDIANA NATIONAL BANK	INDIANAPOLIS	IN	121.5	44.6	31.2	45.6	36	12	1
13	GREAT WESTERN SAVINGS	CHATSWORTH	CA	115.1	85.0	25.2	5.0	13	17	28
14	FLORIDA FEDERAL SAVINGS BANK	ST. PETERSBURG	FL	113.8	91.7	14.7	7.4	12	32	12
15	NORTH CAROLINA NATIONAL BANK (TEXAS)	DALLAS	TX	106.7	77.5	23.2	6.0	14	19	22
16	VALLEY NATIONAL BANK OF ARIZONA	PHOENIX	AZ	102.9	71.1	20.4	11.4	17	23	8
17	SIGNET BANK	BALTIMORE	MD	98.8	77.2	13.3	8.2	15	38	10
18	MANUFACTURERS HANOVER TRUST CO.	HICKSVILLE	NY	93.1	68.4	21.6	3.0	19	22	48
19	UNION BANK & TRUST CO.	LINCOLN	NE	87.9	60.1	23.0	4.8	22	21	31
20	BANK ONE, NA (OHIO)	COLUMBUS	OH	86.9	62.2	17.7	7.1	20	27	14
21	TWIN CITY BANK FOR SAVINGS, FSB	MINNEAPOLIS	MN	86.4	68.9	14.1	3.5	18	34	42
22	TRANS WORLD INSURANCE CO.	SACRAMENTO	CA	85.5	54.3	27.3	3.9	26	15	34
23	PITTSBURGH NATIONAL BANK	PITTSBURGH	PA	84.6	74.3	3.2	7.2	16	91	13
24	BANK IV, NA	WICHITA	KS	80.5	48.1	30.4	2.0	33	13	69
25	BANK ONE, NA (INDIANA)	INDIANAPOLIS	IN	79.7	53.6	19.4	6.8	27	25	18
26	BANK OF NEW ENGLAND	WORCESTER	MA	74.3	43.4	25.3	5.7	39	16	23
27	FIRST BANK, NA (WISCONSIN)	MILWAUKEE	WI	73.8	52.2	18.2	3.5	28	26	41
28	CRESTAR BANK	RICHMOND	VA	73.8	48.4	19.9	5.4	32	24	26
29	FIRST INTERSTATE BANK OF ARIZONA, NA	PHOENIX	AZ	69.7	51.7	12.5	5.5	29	38	25
30	WINDSOR SAVINGS ASSN	AUSTIN	TX	68.9	45.0	23.1	0.8	34	20	*
31	COLLEGE FOUNDATION	RALEIGH	NC	68.3	55.2	6.1	7.0	25	59	16
32	MID-CONTINENT FEDERAL S & L ASSN.	EL DORADO	KS	66.3	38.3	27.6	0.4	47	14	*
33	GLENDALE FEDERAL S & L ASSN.	GLENDALE	CA	64.3	37.6	24.9	1.8	50	18	74
34	PENNSYLVANIA HIGHER ED ASST AGENCY	HARRISBURG	PA	63.7	60.1	3.2	0.4	23	92	*
35	CENTRUST BANK	MIAMI BEACH	FL	62.7	50.8	8.4	3.5	30	47	40
36	SOUTH CAROLINA STUD LOAN CORP	COLUMBIA	SC	60.5	55.4	0.0	5.2	24	*	27
37	WELLS FARGO BANK, NA	WALNUT CREEK	CA	60.2	60.2	0.0	0.0	21	*	*
38	HOWARD SAVINGS BANK	LIVINGSTON	NJ	60.1	42.5	12.0	5.6	40	40	24
39	NORSTAR BANK	SCHENECTADY	NY	54.9	43.6	6.6	4.8	38	57	30
40	FIRST INTERSTATE BANK OF CALIFORNIA	POMONA	CA	53.8	39.7	12.1	1.9	44	39	71
41	AMERITRUST COMPANY, NA	CLEVELAND	OH	53.8	39.4	11.3	3.1	46	42	47
42	INDEPENDENCE FEDERAL SAVINGS BANK	WASHINGTON, D.C.	DC	53.8	41.4	11.0	1.4	41	43	93
43	U.S. BANK OF WASHINGTON, NA	SPOKANE	WA	52.8	41.2	8.5	3.1	42	46	45
44	U.S. BANK OF OREGON, NA	PORTLAND	OR	51.5	44.3	4.5	2.7	37	80	52
45	FIRST INTERSTATE BANK OF DENVER	DENVER	CO	51.4	44.9	5.5	1.1	35	67	*
46	FIRST NATIONWIDE BANK, FSB	SACRAMENTO	CA	51.0	32.1	15.0	3.9	57	30	35
47	MERCHANTS NATIONAL BANK	TOPEKA	KS	49.1	49.1	0.0	0.0	31	*	*
48	FIRST INDEPENDENT TRUST CO.	SACRAMENTO	CA	48.9	29.3	17.4	2.2	62	28	63
49	BAY BANK, NA	DEDHAM	MA	48.4	39.7	7.1	1.6	45	54	80
50	COMMERCE BANK OF ST. LOUIS	ST. LOUIS	MO	46.8	37.7	5.9	3.2	49	65	43

"*" INDICATES RANKING NOT IN TOP 100

TOP 100 GSLP, STAFFORD, SLS, AND PLUS LOAN ORIGINATORS FOR FY 1989

RANK				FY 1989 ORIGINATIONS ($ IN MILLIONS) (SEQUENCED ON TOTAL GSLP FROM HIGH TO LOW)				RANKINGS		
GSLP	LENDER NAME	CITY	ST	TOTAL GSLP	STAFFORD	SLS	PLUS	STAF	SLS	PLUS
51	ONE VALLEY BANK, NA	CHARLESTON	WV	45.4	35.8	8.1	1.5	51	48	88
52	MARYLAND NATIONAL BANK	BALTIMORE	MD	44.4	29.7	8.6	6.1	60	45	21
53	GLENDALE FEDERAL BANK, FSB	FORT LAUDERDALE	FL	44.4	35.5	8.0	0.9	52	49	*
54	FLORIDA NATIONAL BANK	JACKSONVILLE	FL	43.5	38.0	4.9	0.6	48	75	*
55	REPUBLIC CAPITAL BANK	MILWAUKEE	WI	43.3	27.0	14.6	1.7	68	33	77
56	BANK ONE, NA (TEXAS)	FORT WORTH	TX	43.0	33.7	5.4	3.8	54	68	37
57	FIRST INTERSTATE BANK OF OREGON	PORTLAND	OR	42.9	40.1	0.7	2.2	43	*	64
58	UNITED BANK GROUP OF COLORADO	DENVER	CO	40.5	32.8	5.4	2.3	55	69	59
59	FARMERS & MERCHANTS BANK	COLBY	KS	40.3	24.6	14.9	0.8	74	31	*
60	SOVRAN BANK, NA	RICHMOND	VA	39.3	34.8	2.2	2.3	53	*	60
61	BANKERS CREDIT CORP.	WACO	TX	38.9	26.1	11.4	1.5	72	41	89
62	TEXAS COMMERCE BANK, NA	HOUSTON	TX	38.4	32.4	3.8	2.2	56	85	62
63	SEATTLE FIRST NATIONAL BANK	SEATTLE	WA	37.5	26.7	7.1	3.7	69	53	38
64	FIRST INTERSTATE BANK OF OKLAHOMA	OKLAHOMA CITY	OK	37.3	25.2	7.6	4.5	73	51	32
65	NATIONAL CITY BANK	CLEVELAND	OH	37.3	29.0	4.4	3.9	63	81	33
66	UNION BANK & TRUST CO.	DES MOINES	IA	36.7	27.8	6.2	2.7	65	58	34
67	FIRST BANK, NA (MINNESOTA)	MINNEAPOLIS	MN	36.1	29.8	4.7	1.6	59	77	83
68	CERTIFIED SAVINGS ASSN	AUSTIN	TX	33.6	31.2	1.7	0.7	58	*	*
69	BANK OF NORTH DAKOTA	BISMARCK	ND	33.1	28.7	1.5	2.9	64	*	50
70	TEXAS COORDINATING BOARD	AUSTIN	TX	32.9	27.0	5.9	0.0	67	64	*
71	BANCNET EDUCATIONAL LENDING SERVICE	AUSTIN	TX	31.8	23.0	7.8	1.0	79	50	*
72	ZIONS FIRST NATIONAL BANK	SALT LAKE CITY	UT	31.6	29.7	1.4	0.5	61	*	*
73	FIRST TENNESSEE BANK	MARYVILLE	TN	31.1	22.9	6.0	2.1	80	62	68
74	CONTINENTAL FEDERAL S & L ASSN.	OKLAHOMA CITY	OK	30.2	21.1	6.0	3.1	85	63	46
75	FIRST OF AMERICA BANK, NA	KALAMAZOO	MI	28.5	27.5	0.3	0.7	66	*	*
76	FIDELITY BANK, NA	UPPER DARBY	PA	28.1	26.4	0.7	1.1	71	*	*
77	VILLAGE SAVINGS BANK, FSB	HOUSTON	TX	27.6	18.1	8.9	0.6	100	44	*
78	FIRST ATLANTA	ATLANTA	GA	27.5	21.9	2.7	2.9	82	100	51
79	FIRST CITY, TEXAS, NA	HOUSTON	TX	27.4	23.7	2.2	1.5	75	*	86
80	STILLWATER NATIONAL BANK	STILLWATER	OK	27.4	17.2	7.1	3.1	*	95	44
81	CITICORP SAVINGS (ILLINOIS)	CHICAGO	IL	26.7	26.7	0.0	0.0	70	*	*
82	OKLAHOMA STUDENT LOAN AUTHORITY	OKLAHOMA CITY	OK	26.4	13.3	6.9	6.2	*	56	20
83	FIRST NATIONAL BANK OF CHICAGO	CHICAGO	IL	26.4	20.4	5.2	0.8	89	71	*
84	CHASE LINCOLN FIRST BANK, NA	ROCHESTER	NY	26.2	20.7	3.5	2.1	88	88	67
85	MIDAMERICAN BANK & TRUST CO.	SHAWNEE MISSION	KS	26.0	13.1	12.7	0.2	*	37	*
86	PREMIER BANK, NA	BATON ROUGE	LA	25.5	18.9	3.9	2.7	94	83	53
87	KEY BANK, NA (NEW YORK)	ALBANY	NY	25.4	20.8	2.8	1.8	87	99	75
88	MERIDIAN BANK	READING	PA	25.1	23.3	0.8	0.9	77	*	*
89	DOMINION BANK, NA	ROANOKE	VA	24.8	21.6	1.1	2.1	83	*	65
90	FIRST WISCONSIN NATIONAL BANK	MILWAUKEE	WI	24.5	21.3	1.4	1.7	84	*	76
91	FIRST SECURITY BANK OF UTAH, NA	SALT LAKE CITY	UT	24.1	23.2	0.7	0.3	78	*	*
92	FIRST NATIONAL BANK	LUBBOCK	TX	24.0	19.2	3.9	0.9	92	84	*
93	SIMMONS FIRST NATIONAL BANK	PINE BLUFF	AR	23.9	19.1	1.9	2.9	93	*	49
94	SOUTHTRUST BANK OF ALABAMA, NA	BIRMINGHAM	AL	23.7	20.0	2.4	1.3	90	*	96
95	IMPERIAL SAVINGS	SAN DIEGO	CA	23.4	23.4	0.0	0.0	76	*	*
96	FIRST NATIONAL BANK OF COMMERCE	NEW ORLEANS	LA	22.9	18.5	3.0	1.4	98	97	92
97	FIRST AMERICAN SAVINGS, INC	TUCSON	AZ	22.6	22.6	0.0	0.0	81	*	*
98	KEY BANK OF MAINE	AUGUSTA	ME	22.2	15.9	6.0	0.2	*	81	*
99	NATIONAL BANK OF DETROIT	DETROIT	MI	22.1	21.0	0.8	0.3	86	*	*
100	FIRST NATIONAL BANK OF BOSTON	BOSTON	MA	21.9	18.6	2.6	0.7	97	*	*

"*" INDICATES RANKING NOT IN TOP 100

TOP 100 GSLP, STAFFORD, SLS, AND PLUS LOAN ORIGINATORS FOR FY 1989

RANK				FY 1989 ORIGINATIONS ($ IN MILLIONS) (SEQUENCED ON TOTAL GSLP FROM HIGH TO LOW)				RANKINGS		
GSLP	LENDER NAME	CITY	ST	TOTAL GSLP	STAFFORD	SLS	PLUS	STAF	SLS	PLUS
*	FIRST AMERICAN NATIONAL BANK	NASHVILLE	TN	20.8	19.3	0.0	1.5	91	*	85
*	MICHIGAN NATIONAL BANK	CLAWSON	MI	18.8	18.8	0.0	0.0	95	*	*
*	FIRST PENNSYLVANIA BANK, NA	PHILADELPHIA	PA	20.5	18.8	0.7	0.9	96	*	*
*	CARTERET SAVINGS BANK	PARSIPPANY	NJ	18.4	18.1	0.1	0.2	93	*	*
*	NEBRASKA HIGHER ED LOAN PROGRAM	LINCOLN	NE	21.8	0.0	16.8	5.0	*	29	29
*	IMPERIAL SAVINGS ASSN	WICHITA	KS	14.8	0.0	14.0	0.9	*	35	*
*	TAYLORBANC FEDERAL SAVINGS	HUTTO	TX	19.4	11.7	7.2	0.5	*	52	*
*	ONONDAGA SAVINGS BANK	SYRACUSE	NY	17.8	11.2	6.1	0.6	*	60	*
*	RIVER FOREST STATE BANK	RIVER FOREST	IL	15.9	9.5	5.7	0.8	*	66	*
*	SOUTHSIDE STATE BANK	TYLER	TX	17.5	10.5	5.4	1.6	*	70	81
*	VENTURA COUNTY NATIONAL BANK	OXNARD	CA	18.7	13.0	5.1	0.6	*	72	*
*	ANCHOR SAVINGS ASSN.	SHAWNEE MISSION	KS	20.6	14.7	5.1	0.8	*	73	*
*	DENVER NATIONAL BANK	DENVER	CO	15.0	9.1	5.0	1.0	*	74	70
*	KIRKSVILLE COL OF OSTEOPATHIC MED	KIRKSVILLE	MO	13.7	8.9	4.8	0.0	*	76	*
*	MERCHANTS NATIONAL BANK & TR CO.	INDIANAPOLIS	IN	21.3	13.0	4.6	3.7	*	78	39
*	MERABANK	PHOENIX	AZ	19.8	14.4	4.8	0.6	*	79	*
*	FIRST FEDERAL SAVINGS & LOAN ASSN.	ROCHESTER	NY	12.3	8.3	4.0	0.0	*	82	*
*	HARVARD UNIVERSITY	CAMBRIDGE	MA	19.3	15.5	3.8	0.0	*	85	*
*	DEPOSIT GUARANTY NATIONAL BANK	JACKSON	MS	19.8	14.6	3.6	1.6	*	87	84
*	TEXAS AMERICAN BANK, NA	AMARILLO	TX	16.4	12.2	3.4	0.8	*	89	*
*	PACKERS BANK & TRUST CO.	OMAHA	NE	11.5	7.7	3.2	0.6	*	90	*
*	ANTOINE NATIONAL BANK	HOUSTON	TX	7.0	3.8	3.2	0.1	*	93	*
*	GOLDOME BANK	AMHERST	NY	18.9	15.1	3.1	0.7	*	94	*
*	FIRST UNITED BANK	FARMERVILLE	LA	20.4	15.2	3.1	2.0	*	95	68
*	COMMERCIAL NATIONAL BANK	SHREVEPORT	LA	21.4	15.9	3.0	2.4	*	96	56
*	AETNA BANK	CHICAGO	IL	20.4	17.0	2.9	0.4	*	98	*
*	SOUTHERN SECURITY LIFE INSURANCE CO.	MAITLAND	FL	8.9	1.5	0.4	7.1	*	*	15
*	NAVY FEDERAL CREDIT UNION	MERRIFIELD	VA	15.6	9.6	2.2	3.8	*	*	36
*	BANK ONE, NA (WISCONSIN)	MILWAUKEE	WI	17.4	12.6	2.3	2.5	*	*	55
*	VERMONT EDUCATION LOAN FINANCE PROG	WINOOSKI	VT	11.8	7.8	1.6	2.4	*	*	57
*	CENTRAL FIDELITY BANK	LYNCHBURG	VA	12.1	8.9	0.8	2.3	*	*	61
*	FIRST NATIONAL BANK	DAYTON	OH	11.2	7.1	2.3	1.8	*	*	72
*	FIRST FINANCIAL BANK, FSB	STEVENS POINT	WI	15.4	11.7	1.8	1.8	*	*	73
*	SOCIETY BANK, NA	DAYTON	OH	16.0	13.3	1.0	1.7	*	*	78
*	UNITED BANK & TRUST CO.	HARTFORD	CT	14.4	11.2	1.5	1.7	*	*	79
*	FIRST SECURITY NATIONAL BANK	NORCROSS	GA	13.5	11.9	0.0	1.6	*	*	82
*	DIXIE NATIONAL LIFE INSURANCE CO.	JACKSON	MS	2.9	1.2	0.2	1.5	*	*	87
*	HIBERNIA NATIONAL BANK	NEW ORLEANS	LA	15.9	12.7	1.6	1.5	*	*	90
*	KENTUCKY HIGHER ED STUDENT LOAN CORP	FRANKFORT	KY	2.2	0.0	0.8	1.4	*	*	91
*	HUNTINGTON NATIONAL BANK	COLUMBUS	OH	14.8	12.5	1.0	1.4	*	*	94
*	FIRST NATIONAL BANK	BOULDER	CO	16.1	12.3	2.5	1.4	*	*	95
*	DECATUR FEDERAL SAVINGS & LOAN ASSN.	DECATUR	GA	7.8	5.6	1.0	1.2	*	*	97
*	AMSOUTH BANK, NA	BIRMINGHAM	AL	15.6	14.3	0.0	1.2	*	*	98
*	EMPIRE OF AMERICA, FSB	WILLIAMSVILLE	NY	20.1	16.7	2.2	1.2	*	*	99
*	FIRST BANK, NA	ABERDEEN	SD	10.3	8.2	0.9	1.2	*	*	100

"*" INDICATES RANKING NOT IN TOP 100

	TOTAL GSLP	STAFFORD	SLS	PLUS
TOP 10 AS A % OF NATION	23.5	21.1	36.4	27.9
TOP 25 AS A % OF NATION	36.7	33.2	57.0	41.9
TOP 50 AS A % OF NATION	49.8	45.8	73.8	55.7
TOP 75 AS A % OF NATION	58.1	54.2	81.9	63.7
TOP 100 AS A % OF NATION	63.6	60.0	86.9	68.9

GUARANTEE AGENCIES

ALABAMA
Alabama Commission on
Higher Education
1 Court Square, Suite 221
Montgomery, Alabama
36197-0001
(205) 269-2700

ALASKA
Alaska Commission on
Postsecondary Education
400 Willoughby Avenue
Box FP
Juneau, Alaska 99811
(907) 465-2854

ARIZONA
Arizona Educational
Loan Program
1400 East Southern
Suite 200
Tempe, Arizona 85282
(602) 831-9988

ARKANSAS
Student Loan
Guarantee Foundation
of Arkansas
219 South Victory
Little Rock, Arkansas
72201-1884
(501) 372-1491

CALIFORNIA
California Student Aid Commission
P.O. Box 942845
1515 S Street
North Building, Suite 500
Sacramento, California 94245-0845
(916) 323-0435
(916) 445-0880

COLORADO
Colorado Guaranteed
Student Loan Program
999 18th Street, Suite 425
Denver, Colorado 80202
(303) 294-5070 (status check)
(303) 294-5050 (main number)

CONNECTICUT
Connecticut Student
Loan Foundation
525 Brook Street
Rocky Hills, Connecticut
06067
(203) 257-4001

DELAWARE
Delaware Higher
Education Loan Program
Carvel State Office Building
820 North French Street
4th Floor
Wilmington, Delaware 19801
(302) 571-2754
(302) 571-6055

DISTRICT OF COLUMBIA
Higher Education
Loan Program of
Washington, D.C.
1023 15th St., N.W.
10th Floor
Suite 1000
Washington, D.C. 20005
(202) 289-4500

FLORIDA
Office of Student
Financial Assistance
Department of Education
Room 1344, Federal Program Unit
Florida Education Center
Tallahassee, Florida 32399-0400
(904) 488-8093
(904) 488-4095

GEORGIA
Georgia Student
Finance Commission
2082 East Exchange Place
Suite 200
Tucker, Georgia 30084
(404) 493-5412

HAWAII
Hawaii Education
Loan Program
P.O. Box 22187
Honolulu, Hawaii
96822-0187
(808) 536-3731

IDAHO
Student Loan Fund of Idaho, Inc.
Processing Center
P.O. Box 730
Fruitland, Idaho 83619
(208) 452-4058

ILLINOIS
Illinois Student Assistance
Commission
106 Wilmot Road
Deerfield, Illinois 60015
(708) 948-8550

INDIANA
State Student Assistance
Commission of Indiana
964 North Pennsylvania
Street
Indianapolis, Indiana
46204
(317) 232-2366

IOWA
Iowa College Aid
Commission
201 Jewett Building
9th and Grand Avenue
Des Moines, Iowa 50309
(515) 281-4890

KANSAS
Higher Education
Assistance Foundation
6800 College Blvd.
Suite 600
Overland Park, Kansas
66211-1532
(913) 345-1300

KENTUCKY
Kentucky Higher
Education Assistance
Authority
1050 U.S. 127 South
Suite 102
Frankfort, Kentucky 40601
(502) 564-7990

LOUISIANA
Governor's Special
Commission on Education
Services
P.O. Box 91202
Baton Rouge, Louisiana
70821-9202
(504) 922-1011

MAINE
Maine Department of
Education and Cultural
Services
Division of Higher
Education Services
State House Station 119
Augusta, Maine 04333
(207) 289-2183

MARYLAND
Maryland
Higher Education
Loan Corporation
2100 Guilford Avenue
Room 305
Baltimore, Maryland 21218
(301) 333-6555

MASSACHUSETTS
Massachusetts
Higher Education
Assistance Corporation
Berkeley Place
330 Stuart Street
Boston, Massachusetts
02116
(617) 426-9434

MICHIGAN
Michigan
Department of Education
Guaranteed Student Loan
Program
Box 30047
Lansing, Michigan 48909
(517) 373-0760

MINNESOTA
Higher Education
Assistance Foundation
85 East 7th Street
Suite 500
St. Paul, Minnesota 55101
(612) 227-7661

MISSISSIPPI
Mississippi Guarantee
Student Loan Agency
3825 Ridgewood Road
P.O. Box 342
Jackson, Mississippi
39205-0342
(601) 982-6663

MISSOURI
Coordinating Board for
Higher Education
P.O. Box 1438
Jefferson City, Missouri
65102
(314) 751-3940

MONTANA
Montana Guaranteed
Student Loan Program
35 South Last Chance Gulch
Helena, Montana 59620-3104
(406) 444-6594

NEBRASKA
Higher Education Assistance
Foundation
Cornhusker Bank Building
11th and Cornhusker Highway
Suite 304
Lincoln, Nebraska 68521
(402) 476-9129

Nebraska Student Loan Program
1300 O Street
P.O. Box 82505
Lincoln, Nebraska 68501
(402) 475-8686

NEVADA

(see United Student Aid Funds, Inc.)

NEW HAMPSHIRE
New Hampshire
Higher Education
Assistance Foundation
P.O. Box 877
Concord, New Hampshire 03302
(603) 225-6612
(800) 235-2577 (within New Hampshire)
(800) 525-2577 (outside New Hampshire)

NEW JERSEY
New Jersey Higher
Education Assistance
Authority
C.N. 543
Trenton, New Jersey 08625
(609) 588-3200

NEW MEXICO
New Mexico Educational
Assistance Foundation
P.O. Box 27020
Albuquerque, New Mexico
87125-7020
(505) 345-3371

NEW YORK
New York State Higher
Education Services
Corporation
99 Washington Avenue
Albany, New York 12255
(518) 473-1668

NORTH CAROLINA
North Carolina State
Education Assistance
Authority
P.O. Box 2688
Chapel Hill, North Carolina
27515-2688
(919) 549-8614

NORTH DAKOTA
Bank of North Dakota
Student Loan Department
P.O. Box 5509
Bismarck, North Dakota
58502-5509
(701) 224-5600

OHIO
Ohio Student Loan
Commission
P.O. Box 16610
Columbus, Ohio
43266-0610
(614) 466-3091

OKLAHOMA
Oklahoma State Regents
for Higher Education
500 Education Building
State Capitol Complex
Oklahoma City, Oklahoma
73105
(405) 524-9100

OREGON
Oregon State
Scholarship Commission
1445 Willamette Street
Eugene, Oregon 97401
(503) 346-3200
(800) 452-8807
(within Oregon)

PENNSYLVANIA
Pennsylvania Higher
Education Assistance
Agency
660 Boas Street
Harrisburg, Pennsylvania
17102
(800) 692-7392

RHODE ISLAND
Rhode Island Higher
Education Assistance
Authority
560 Jefferson Boulevard
Warwick, Rhode Island
02886
(401) 277-2050
Out of State Toll Free—
(800) 922-9855

SOUTH CAROLINA
South Carolina
Student Loan
Corporation
Interstate Center, Suite 210
P.O. Box 21487
Columbia, South Carolina
29221
(803) 798-0916

SOUTH DAKOTA
Education
Assistance Corporation
115 First Avenue, S.W.
Aberdeen, South Dakota
57401
(605) 225-6423

TENNESSEE
Tennessee Student
Assistance Corporation
404 James Robertson Parkway
Suite 1950, Parkway Tower
Nashville, Tennessee
37243-0820
(615) 741-1346
(800) 342-1663 (within Tennessee)

TEXAS
Texas Guaranteed Student
Loan Corporation
P.O. Box 15996
Austin, Texas 78761
(512) 835-1900

UTAH
Loan Servicing Corp.
of Utah
P.O. Box 30802
Salt Lake City, Utah
84130-0802
(801) 975-2222

VERMONT
Vermont Student
Assistance Corporation
Champlain Mill
P.O. Box 2000
Winooski, Vermont
05404-2000
(802) 655-9602
(800) 642-3177
(within Vermont)

VIRGINIA
State Education
Assistance Authority
1 Franklin Square
411 East Franklin Street
Suite 300
Richmond, Virginia 23219
(804) 786-2035

WASHINGTON
Washington Student
Loan Guaranty
Association
500 Coleman Building
811 First Avenue
Seattle, Washington 98104
(206) 625-1030

WEST VIRGINIA
Higher Education
Assistance Foundation
Higher Education
Loan Program of
West Virginia, Inc.
P.O. Box 591
Charleston, West Virginia
25322
(304) 345-7211

WISCONSIN
Great Lakes Higher
Education Corporation
2401 International Lane
Madison, Wisconsin 53704
(608) 246-1800

WYOMING
Higher Education
Assistance Foundation
1912 Capitol Avenue
Suite 320
Cheyenne, Wyoming 82003
(307) 635-3259

AMERICAN SAMOA
Pacific Islands
Educational Loan Program
United Student Aid
Funds, Inc.
1314 South King Street
Suite 961
Honolulu, Hawaii 96814
(808) 536-3731

NORTHERN MARIANA
ISLANDS

See American Samoa

FEDERATED STATES
OF MICRONESIA
MARSHALL ISLANDS
REPUBLIC OF PALAU

See American Samoa

VIRGIN ISLANDS
Virgin Islands
Board of Education
P.O. Box 11900
St. Thomas, Virgin Islands
00801
(809) 774-4546

GUAM

See American Samoa

PUERTO RICO
Higher Education
Assistance Corporation
P.O. Box 23305
UPR Station
Rio Piedras, Puerto Rico 00931
(809) 758-3356/3328

USAF, INC.
United Student Aid Funds, Inc.
Processing Center
P.O. Box 50437
Indianapolis, Indiana 46250
(800) 382-4506 (within Indiana)
(800) 824-7044

COMPARATIVE DUE DILIGENCE

	DAYS	0	31	61	91	121	151 180
REQUIREMENT	STANDARD GSL PROGRAM	2 WRITTEN NOTICES	DILIGENT PHONE EFFORT 2 LETTERS	DILIGENT PHONE EFFORT 1 LETTER	DILIGENT PHONE EFFORT 1 LETTER	DILIGENT PHONE EFFORT 1 LETTER	FINAL DEMAND
	SALLIE MAE REQUIREMENTS	2 WRITTEN NOTICES	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 2 LETTERS	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	FINAL DEMAND
CATEGORY OF BORROWER	PAYING BORROWERS	PAYMENT					
	DELINQUENT BORROWER	2 WRITTEN NOTICES	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 2 LETTERS	PAYMENT			
	ROLLING		MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 2 LETTERS	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	2 PAYMENTS	
	DELINQUENCY			MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	FINAL DEMAND 2 PAYMENTS
					MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	MULTIPLE PHONE ATTEMPTS PLEASE CALL LETTERS 1 LETTER	

APPENDIX "D"

GUARANTEED STUDENT LOAN PROGRAMS -- 100 LEADING CURRENT HOLDERS --- FY88

	LENDER NAME	$ OUTSTANDING AS OF 9/30/88	CITY	ST.	[1]
1.	SALLIE MAE	11,317.8	WASHINGTON, D.C.	DC	13
2.	CITIBANK, NA (NEW YORK)	1,891.5	ROCHESTER	NY	1
3.	CALIF. STUD LOAN FINANCE CORP.	1,314.0	LOS ANGELES	CA	31
4.	CHASE MANHATTAN BK, NA (NEW YORK)	867.4	NEW HYDE PARK	NY	4
5.	NEBRASKA HIGHER EDUC LOAN PROG.	837.0	LINCOLN	NE	2
6.	CHEMICAL BANK (NEW YORK)	729.7	JERICHO	NY	6
7.	NEW ENGLAND ED LN MARKET. CORP.	587.7	BRAINTREE	MA	5
8.	FLORIDA FEDERAL SAVINGS BANK	574.0	ST. PETERSBURG	FL	1
9.	MARINE MIDLAND BK, NA (NEW YORK)	506.1	BUFFALO	NY	1
10.	MANUFACTURERS HANOVER TRUST CO.	424.3	HICKSVILLE	NY	1
11.	PITTSBURGH NATIONAL BANK	378.8	PITTSBURGH	PA	1
12.	MARINE MIDLAND BK, NA (DELAWARE)	367.1	WILMINGTON	DE	6
13.	VIRGINIA EDUCATION LOAN AUTH.	357.3	RICHMOND	VA	1
14.	MELLON BANK, NA	319.2	PITTSBURGH	PA	6
15.	BANK OF AMERICA, NA	317.7	LOS ANGELES	CA	1
16.	COLLEGE FOUNDATION	314.8	RALEIGH	NC	1
17.	INDIANA SECONDARY MARKET	307.4	INDIANAPOLIS	IN	1
18.	EMPIRE OF AMERICA, FSA	283.6	WILLIAMSVILLE	NY	5
19.	KENTUCKY HIGHER ED STUD LN CORP	266.5	FRANKFORT	KY	1
20.	HIGHER EDUC LOAN PROG. OF KANSAS	258.1	OVERLAND PARK	KS	2
21.	SIGNET BANK (MARYLAND)	253.8	BALTIMORE	MD	1
22.	SOUTH DAKOTA STUDENT LOAN CORP.	250.4	ABERDEEN	SD	1
23.	STUDENT LOAN FUNDING CORPORATION	245.5	CINCINNATI	OH	4
24.	CHASE LINCOLN FIRST BANK, NA	238.2	ROCHESTER	NY	2
25.	BANK ONE, NA (OHIO)	227.5	COLUMBUS	OH	20
26.	WACHOVIA BANK & TRUST COMPANY	208.1	WINSTON-SALEM	NC	3
27.	NORSTAR BANK	205.4	SYRACUSE	NY	6
28.	HOWARD SAVINGS BANK	200.5	LIVINGSTON	NJ	1
29.	PENNA. HIGHER EDUC ASST AGENCY	[illegible]	HARRISBURG	PA	2
30.	FIRST INTERSTATE BANK OF ARIZONA	191.0	PHOENIX	AZ	1
31.	WESTERN LOAN MARKETING ASSO.	188.7	SCOTTSDALE	AZ	3
32.	ILL. DESIGNATED ACCT PURCH PROG	[illegible]	DEERFIELD	IL	2
33.	FIDELITY BANK	[illegible]	UPPER DARBY	PA	1
34.	NORWEST BANK OF SOUTH DAKOTA, NA	171.3	SIOUX FALLS	SD	8
35.	CENTRUST SAVINGS BANK	169.2	MIAMI BEACH	FL	1
36.	HAWKEYE BANK & TRUST COMPANY	168.3	DES MOINES	IA	8
37.	IOWA STUDENT LOAN LIQUIDITY CORP	166.1	DES MOINES	IA	1
38.	INDUSTRIAL COMMISSION OF N. DAK.	164.9	BISMARCK	ND	1
39.	UTAH STATE BOARD OF REGENTS	164.6	SALT LAKE CITY	UT	3
40.	COLO. STUD OBLIGATION BOND AUTH.	160.9	DENVER	CO	3
41.	CALIFORNIA HIGHER ED LOAN AUTH.	159.3	SACRAMENTO	CA	2
42.	U. S. BANK OF OREGON	150.7	PORTLAND	OR	1
43.	BRAZOS HIGHER EDUCATION AUTH.	149.3	WACO	TX	2
44.	WELLS FARGO BANK, NA	149.1	WALNUT CREEK	CA	2
45.	AMERITRUST COMPANY	146.8	CLEVELAND	OH	7
46.	NATIONAL CITY BANK	140.1	CLEVELAND	OH	8
47.	FIRST INTERSTATE BANK OF OREGON	139.3	PORTLAND	OR	1
48.	GREAT WESTERN SAVINGS	137.2	NORTHRIDGE	CA	1
49.	BOATMEN'S BANK GROUP (MISSOURI)	134.2	ST. LOUIS	MO	26
50.	ONONDAGA SAVINGS BANK	134.0	SYRACUSE	NY	1
51.	BANCO POPULAR DE PUERTO RICO	133.9	SAN JUAN	PR	1
52.	BANCOHIO NATIONAL BANK	132.2	COLUMBUS	OH	1
53.	BRAZOS STUDENT FINANCE CORP.	128.7	WACO	TX	3
54.	MICHIGAN HIGHER ED STUD LN AUTH.	127.2	LANSING	MI	1
55.	TEXAS HIGHER EDUC COORD. BOARD	127.1	AUSTIN	TX	1
56.	INDIANA NATIONAL BANK	124.3	INDIANAPOLIS	IN	1
57.	MISSOURI HIGHER EDUC LOAN AUTH.	122.9	ST. LOUIS	MO	2
58.	HIGHER EDUC LOAN PROGRAM OF D.C.	119.9	WASHINGTON, D.C.	DC	2
59.	ARIZONA ED LOAN MARKETING CORP.	116.0	PHOENIX	AZ	2
60.	UNION BANK & TRUST COMPANY	115.7	LINCOLN	NE	2
61.	RHODE ISLAND STUD LN ASST CORP	114.9	WARWICK	RI	1
62.	MERIDIAN BANK	114.5	READING	PA	1
63.	UNIVERSITY SAVINGS ASSOCIATION	112.2	AUSTIN	TX	1
64.	BAYBANK NORFOLK COUNTY TRUST CO.	107.5	DEDHAM	MA	1
65.	FIRST AMERICA SAVINGS BANK, FSB	107.2	LONGMONT	CO	1
66.	HIGHER EDUC LOAN PROG. OF TENN.	104.8	NASHVILLE	TN	1
67.	MISSISSIPPI HIGHER ED ASST CORP.	104.5	JACKSON	MS	2
68.	FIRST FINANCIAL BANK, FSB	104.3	STEVENS POINT	WI	2
69.	BANK IV, NA	102.9	WICHITA	KS	7
70.	FIRST FIDELITY BANK, NA	101.7	NEWARK	NJ	3
71.	FIRST PENNSYLVANIA BANK, NA	98.1	PHILADELPHIA	PA	1
72.	NORTH TEXAS HIGHER EDUC AUTH.	98.0	ARLINGTON	TX	1
73.	NEW MEXICO EDUC ASST FOUNDATION	97.3	SANTA FE	NM	3
74.	MONTANA HIGHER ED STUD ASST CORP	96.7	HELENA	MT	2
75.	COMMERCE BANK	93.3	ST. LOUIS	MO	1
76.	RIVER FOREST STATE BANK	93.2	RIVER FOREST	IL	2
77.	MINNESOTA HIGHER ED COORD. BOARD	91.2	ST. PAUL	MN	1
78.	AMSOUTH BANK, NA	91.0	BIRMINGHAM	AL	3
79.	WEST TEXAS HIGHER ED AUTHORITY	90.7	GARLAND	TX	2
80.	CROSSLAND SAVINGS BANK	90.5	BROOKLYN	NY	1
81.	STUDENT LOAN FINANCE ASSOCIATION	89.3	SEATTLE	WA	1
82.	VERMONT SECONDARY LOAN MARKET	89.0	WINOOSKI	VT	2
83.	HARVARD UNIVERSITY	88.2	CAMBRIDGE	MA	1
84.	FIRST TENNESSEE BANK	85.0	MARYVILLE	TN	1
85.	OLD KENT BANK & TRUST COMPANY	82.8	GRAND RAPIDS	MI	14
86.	CITICORP SAVINGS OF ILLINOIS	80.4	CHICAGO	IL	1
87.	CHEMICAL BANK, NA (NEW JERSEY)	79.0	MOORESTOWN	NJ	2
88.	UNION NATIONAL BANK	78.7	PITTSBURGH	PA	1
89.	BOSTON FIVE CENTS SAVINGS BANK	77.9	BOSTON	MA	1
90.	MAINE EDUC LOAN MARKETING CORP.	77.7	AUGUSTA	ME	1
91.	OKLAHOMA STUDENT LOAN PROGRAM	76.0	OKLAHOMA CITY	OK	1
92.	VALLEY NATIONAL BANK	76.0	PHOENIX	AZ	1
93.	SOUTH TEXAS HIGHER ED AUTHORITY	75.5	MC ALLEN	TX	1
94.	ALABAMA HIGHER ED LOAN CORP.	73.8	MONTGOMERY	AL	1
95.	SHAWMUT BANK, NA	72.6	CAMBRIDGE	MA	10
96.	CARTERET SAVINGS BANK	71.5	PARSIPPANY	NJ	1
97.	SOUTH CAROLINA STUD LOAN CORP.	69.8	COLUMBIA	SC	3
98.	CRESTAR BANK	69.4	RICHMOND	VA	1
99.	WISCONSIN HIGHER EDUC AIDS BOARD	69.1	MADISON	WI	1
100.	U.S. BANK OF WASHINGTON, NA	67.8	SPOKANE	WA	1

[1] COUNT OF LENDER IDENTIFICATION NUMBERS COMBINED.

NOTES: (1) $ IN MILLIONS.
(2) SOURCE: CALL REPORT
(3) INCLUDES STAFFORD, PLUS, SLS & CONSOLIDATION LOANS.

TOP 100 : 32,909.1 = (72% OF ALL OUTSTANDING LOANS)
TOP 75 : 30,505.8 = (68% OF ALL OUTSTANDING LOANS)
TOP 50 : 27,899.8 = (61% OF ALL OUTSTANDING LOANS)
TOP 25 : 23,535.0 = (52% OF ALL OUTSTANDING LOANS)

APPENDIX "E"

GUARANTEED STUDENT LOAN PROGRAMS — 100 LEADING CURRENT HOLDERS --- AS OF 9/30/89

	LENDER NAME	$ OUTSTANDING AS OF 9/30/89 (IN MILLIONS)	STATE	[1]	88 RANK
1.	SALLIE MAE	13,483.3	D. C.	12	1
2.	CITIBANK, NA (NEW YORK)	2,104.2	NEW YORK	1	2
3.	CALIFORNIA STUD LOAN FINANCE CORP.	1,147.0	CALIFORNIA	25	3
4.	NEBRASKA HIGHER EDUC LOAN PROG.	1,057.8	NEBRASKA	2	5
5.	CHASE MANHATTAN BANK, NA (NEW YORK)	954.7	FLORIDA	6	4
6.	CHEMICAL BANK (NEW YORK)	858.4	NEW YORK	8	6
7.	NEW ENGLAND EDUC LOAN MARKET. CORP.	776.2	MASSACHUSETTS	5	7
8.	PENNA. HIGHER EDUC ASST AGENCY	521.3	PENNSYLVANIA	2	29
9.	MARINE MIDLAND BANK, NA (NEW YORK)	503.1	NEW YORK	1	9
10.	MANUFACTURERS HANOVER TRUST CO.	456.3	NEW YORK	2	10
11.	BANK OF AMERICA, NA	452.5	CALIFORNIA	1	15
12.	FLORIDA FEDERAL SAVINGS BANK	430.4	FLORIDA	2	8
13.	MARINE MIDLAND BANK, NA (DELAWARE)	420.3	DELAWARE	6	12
14.	PITTSBURGH NATIONAL BANK	410.0	PENNSYLVANIA	1	11
15.	HIGHER EDUC LOAN PROGRAM OF KANSAS	402.6	KANSAS	2	20
16.	INDIANA SECONDARY MARKET	395.0	INDIANA	1	17
17.	MELLON BANK, NA	361.7	PENNSYLVANIA	8	14
18.	COLLEGE FOUNDATION	341.1	NORTH CAROLINA	1	16
19.	VIRGINIA EDUCATION LOAN AUTHORITY	338.6	VIRGINIA	1	13
20.	BRAZOS HIGHER EDUCATION AUTHORITY	307.3	TEXAS	2	43
21.	STUDENT LOAN FUNDING CORPORATION	305.0	OHIO	5	23
22.	SOUTH DAKOTA STUDENT LOAN CORP.	263.0	SOUTH DAKOTA	1	22
23.	KENTUCKY HIGHER EDUC STUD LN CORP	260.8	KENTUCKY	1	19
24.	NORWEST BANK OF SOUTH DAKOTA, NA	252.1	SOUTH DAKOTA	8	34
25.	SIGNET BANK (MARYLAND)	237.2	MARYLAND	1	21
26.	NORSTAR BANK	235.9	NEW YORK	6	27
27.	HOWARD SAVINGS BANK	235.4	NEW JERSEY	1	28
28.	EMPIRE OF AMERICA, FSA	232.2	NEW YORK	7	18
29.	ILL. DESIGNATED ACCT PURCH PROG	226.5	ILLINOIS	1	32
30.	CHASE LINCOLN FIRST BANK, NA	222.2	NEW YORK	2	24
31.	BANK OF HORTON	208.2	KANSAS	1	--
32.	CALIFORNIA HIGHER EDUC LOAN AUTH.	205.5	CALIFORNIA	7	41
33.	FIRST INTERSTATE BANK OF ARIZONA	200.2	ARIZONA	1	30
34.	IOWA STUDENT LOAN LIQUIDITY CORP.	199.8	IOWA	1	37
35.	INDIANA NATIONAL BANK	187.6	INDIANA	1	54
36.	ARIZONA EDUC LOAN MARKETING CORP.	185.4	ARIZONA	2	59
37.	ONONDAGA SAVINGS BANK	184.6	NEW YORK	4	50
38.	WACHOVIA BANK & TRUST COMPANY	179.9	NORTH CAROLINA	3	26
39.	FIDELITY BANK	179.2	PENNSYLVANIA	1	33
40.	UTAH STATE BOARD OF REGENTS	173.6	UTAH	3	39
41.	NATIONAL CITY BANK	168.8	OHIO	6	46
42.	U. S. BANK OF OREGON	164.3	OREGON	1	42
43.	WESTERN LOAN MARKETING ASSOCIATION	162.3	ARIZONA	2	31
44.	COLORADO STUD OBLIGATION BOND AUTH.	157.2	COLORADO	3	40
45.	UNION BANK & TRUST COMPANY	156.9	NEBRASKA	2	60
46.	MISSOURI HIGHER EDUC LOAN AUTH.	155.4	MISSOURI	2	57
47.	FIRST INTERSTATE BANK OF OREGON	148.8	OREGON	1	47
48.	GREAT WESTERN SAVINGS	143.4	CALIFORNIA	2	48
49.	INDUSTRIAL COMMISSION OF N. DAKOTA	142.4	NORTH DAKOTA	1	38
50.	BANK ONE, NA (OHIO)	138.1	OHIO	19	25
51.	TEXAS HIGHER EDUC COORD. BOARD	137.2	TEXAS	1	52
52.	RIVER FOREST STATE BANK	136.5	ILLINOIS	2	76
53.	MISSISSIPPI HIGHER EDUC ASST CORP.	134.1	MISSISSIPPI	1	68
54.	BANK OF NEW YORK	132.9	NEW YORK	1	--
55.	NEW MEXICO EDUC ASST FOUNDATION	132.9	NEW MEXICO	3	73
56.	HIGHER EDUC LOAN PROGRAM OF D.C.	132.8	D. C.	2	58
57.	CENTRUST SAVINGS BANK	132.5	FLORIDA	1	35
58.	BANCOHIO NATIONAL BANK	131.4	OHIO	1	67
59.	WELLS FARGO BANK, NA	125.8	CALIFORNIA	3	44
60.	WEST TEXAS HIGHER EDUCATION AUTH.	125.0	TEXAS	5	79
61.	SOUTH CAROLINA STUDENT LOAN CORP.	124.9	SOUTH CAROLINA	3	97
62.	VERMONT SECONDARY LOAN MARKET	123.7	VERMONT	3	63
63.	MERIDIAN BANK	121.4	PENNSYLVANIA	1	55
64.	RHODE ISLAND STUDENT LN ASST CORP	119.7	RHODE ISLAND	1	61
65.	UNION BANK & TRUST CO. / IMELP	119.0	IOWA	1	--
66.	MICHIGAN HIGHER EDUC STUD LN AUTH	118.3	MICHIGAN	1	54
67.	CRESTAR BANK	117.3	VIRGINIA	1	56
68.	SOUTH TEXAS HIGHER EDUC AUTHORITY	117.1	TEXAS	1	93
69.	BOATMEN'S BANK GROUP	116.1	MISSOURI	36	49
70.	NORTH TEXAS HIGHER EDUC AUTHORITY	116.5	TEXAS	1	72
71.	FIRST FINANCIAL BANK, FSB	114.9	WISCONSIN	2	68
72.	BAYBANK NORFOLK COUNTY TRUST CO.	112.0	MASSACHUSETTS	1	64
73.	STUDENT LOAN FINANCE ASSOCIATION	109.7	WASHINGTON	1	81
74.	MONTANA HIGHER EDUC STUD ASST CORP	108.3	MONTANA	2	74
75.	COMMERCE BANK	107.7	MISSOURI	1	75
76.	FIRST PENNSYLVANIA BANK, NA	107.0	PENNSYLVANIA	1	71
77.	AMERITRUST COMPANY	104.7	OHIO	1	45
78.	FIRST FIDELITY BANK, NA	102.6	NEW JERSEY	3	78
79.	FIRST TENNESSEE BANK	101.9	TENNESSEE	1	84
80.	BRAZOS STUDENT FINANCE CORP.	97.7	TEXAS	3	53
81.	TWIN CITY FED. BANK SAVINGS, FSB	93.0	MINNESOTA	2	--
82.	HARVARD UNIVERSITY	92.3	MASSACHUSETTS	1	83
83.	PANHANDLE PLAINS HIGHER EDUC AUTH.	91.5	TEXAS	1	--
84.	NAT'L BANK OF DETROIT - (MICHIGAN)	91.5	MICHIGAN	8	--
85.	OLD KENT BANK & TRUST COMPANY	89.4	MICHIGAN	14	85
86.	MAINE EDUC LOAN MARKETING CORP.	87.8	MAINE	1	90
87.	CROSSLAND SAVINGS BANK	87.0	NEW YORK	1	80
88.	BANK ONE, NA (INDIANA)	86.9	INDIANA	12	--
89.	HIGHER EDUC LOAN PROG. OF TENN.	85.7	TENNESSEE	1	66
90.	GREATER EAST TEXAS HIGHER ED AUTH	86.0	TEXAS	2	--
91.	FLORIDA NATIONAL BANK	85.8	FLORIDA	1	--
92.	MERCHANTS NATIONAL BANK & TRUST CO.	85.8	INDIANA	1	--
93.	FIRST AMERICA SAVINGS BANK, FSB	83.1	COLORADO	1	65
94.	BOSTON FIVE CENTS SAVINGS BANK	81.5	MASSACHUSETTS	1	89
95.	FIRST BANK, NA (WISCONSIN)	80.9	WISCONSIN	5	--
96.	FIRST INTERSTATE BANK OF DENVER	79.8	COLORADO	2	--
97.	CITICORP SAVINGS OF ILLINOIS	79.2	ILLINOIS	2	86
98.	CENTRAL TEXAS HIGHER EDUC AUTH.	79.0	TEXAS	1	--
99.	U.S. BANK OF WASHINGTON, NA	78.8	WASHINGTON	1	100
100.	UNION NATIONAL BANK OF PITTSBURGH	77.9	PENNSYLVANIA	1	88

TOP 100 : 36,916.1 : (74% OF ALL OUTSTANDING $)
TOP 75 : 34,698.1 : (69% OF ALL OUTSTANDING $)
TOP 50 : 31,630.5 : (63% OF ALL OUTSTANDING $)
TOP 25 : 27,036.7 : (54% OF ALL OUTSTANDING $)

[1] COUNT OF LENDER IDENTIFICATION NUMBERS COMBINED.

NOTES: (1) SOURCE: CALL REPORT
(2) INCLUDES STAFFORD, PLUS, SLS & CONSOLIDATION LOANS.

Investors
'deposits' with 'guaranteed' return on investment

Guarantee Agencies
California Student Aid Commission
Higher Education Assistance Foundation
United Student Aid Funds

School Students
loan application
receives guaranteed student loan money to disburse

FIRST INDEPENDENT TRUST COMPANY

Secondary Market
California Student Loan Finance Corp.
trustee: Bank of America
Letter of Credit Banks

Loan Servicing
Secondary Market loan portfolio
United Education and Software

U.S. Department of Education
Headquarters
Interest Payment Processing
Region 9
Inspector General

California State Banking Department

APPENDIX "F"

First Independent Trust Company

First Independent Trust
The INTRUST BANK

[illegible] 12th Street
Sacramento, CA 95814
(916) 441-3031

Full Trust Services • Personal • Estate • Pension

February 17, 1984

First Independent Trust, The INTRUST Bank, has continued to outperform the money market funds, bank and savings and loan, CDs, and money market rates with Trust Rate.

First Independent Trust offers the best rate in town on comparable money markets.

	Annual Rate	*Annual Yield*
First Independent Trust	10.76%	11.20%
Sacramento Valley Bank	9.25%	9.625%
Capital Federal	8.75%	9.143%
Bank of America	8.40%	8.731%
Crocker	8.40%	8.731%
Great Western	8.55%	not available
Sacramento Savings	8.65%	9.034%
Wells Fargo	8.40%	8.787%

In addition, the average for 1 year accounts at banks and savings and loan in the Sacramento area is 9.74.

This is based on an independent survey as of February 10, 1984, for one (1) year accounts of $2,500 or more by Bank of America, Crocker, Wells Fargo, Security Pacific, First Interstate, Great Western, Home Savings, American Savings, Glendale Federal, and California Federal Savings.

Trust Rate is currently earning 10.76% with a yield of 11.20% compounded quarterly.

Trust Rate is determined by the average of the 91-day T-Bill rate, plus 2%.

The guarantee on Trust Rate is the full faith and credit of the U. S. Government, which is exactly the guarantee given if you were to purchase T-Bills. Also, the full faith and credit of the U. S. Government is the highest priority guarantee for a financial instrument; safer than the FDIC or FSLIC which are secondary to the full faith and credit of the U. S. Government.

APPENDIX "G"

Reply to:
P.O. Box 2310
Sacramento, CA 95811

RETIREMENT/SAVINGS

SAFETY FIRST

THE MOST PRUDENT INVESTMENT THAT CAN BE MADE IS . . . . . . (a) AN INVESTMENT IN A FULL FAITH AND CREDIT OBLIGATION OF THE U. S. GOVERNMENT, (b) held by a corporate trustee, (c) under the banking laws of the state of California.

POSITION OF GOVERNMENT SECURITIES: Federal Government securities represent the highest form of credit in the U. S. investment markets, since the obligations represent the full faith and credit of the U. S. Government on direct and fully guaranteed issues. Thus, in investment practice, the yields on U. S. Government securities of varying maturities are the point of departure from a "riskless" prime-quality return for money, from the standpoint of financial risk.

An Act of Congress, in 1789, established the Department of the Treasury and chartered the Secretary of the Treasury with the preparation of plans for the improvement and management of the revenue and the support of the public credit. As the top most sovereignty in the political system of the U. S., the Federal Government has powers which may be invoked to honor its public debt obligations . . . (1) the national tax power, in effect making the national wealth and national income a basis for revenue from which to meet obligations . . .," and (2) the power to "coin money and regulate the value thereof."

The only direct obligations of the United States, i.e., obligations of the United States itself, are U. S. Treasury securities, including Treasury bills, notes, and bonds. The United States is directly obliged to pay the principal and interest on these, and there are permanent, indefinite appropriations available for this purpose. In addition, there are other obligations which are guaranteed as to principal and interest by the United States. One such obligation entitled to the "full faith and credit" of the United States is a guaranteed student loan originated by First Independent Trust, pursuant to the Higher Education Act of 1965, as amended.

Some Federal or Government-sponsored agencies have been authorized by Congress to issue their own obligations. However, not all agency securities are "full faith and credit" obligations of the U. S. Government. The direct and guaranteed obligations together represent the nation's public debt. From the very beginning of the nation, the ability-to-pay and willingness-to-pay record of the U. S. Government has been exemplary.

***Summary:** A full faith and credit U. S. Government obligation held by a California trust bank is prudent and requires no deposit insurance.*

ABSOLUTELY THE MOST PRUDENT INVESTMENT FOR YOUR MONEY . . . .

First Independent Trust Company

The INTRUSTBANK™

First Independent Trust Company, The INTRUSTBANK, is incorporated under the laws of the State of California and received its Banking Charter, Number 1136, in August 1975.

The INTRUSTBANK has established a reputation as a leader in productive, innovative investing. It is, for example, among the 10 largest lenders nationally under the California Guaranteed Student Loan Program (GSL) and is, at present, the only State chartered bank in the California Loans to Assist Students Program (CLAS) for students and their parents.

The INTRUSTBANK's Trust Rate Program can be used for the investment of personal funds, IRAs and Keoghs, corporate pension plans and accounts under court supervision.

The Bank that cares about your tomorrow.

First Independent Trust Company
20 12th Street
Sacramento, CA 95814

"Handle with Care"

More than just a slogan, *"Handle with Care,"* is the commitment of First Independent Trust Company, The INTRUSTBANK, to safeguard our investors' dollars. As a bank, our primary responsibility is preservation of capital, or in a word, *safety*.

How we provide safety

Preservation of capital is accomplished by adhering to the investment regulations of the Treasurer of the United States Government, the Treasurer of the State of California, and the requirements of administrators under the Probate Code. The INTRUSTBANK stands by the wisdom of these regulations and requirements and invests only in those securities approved thereunder.

As an example, the law provides for the investment of tax dollars in an approved list of securities from the time received by the State Treasurer until the State's obligations are paid. The INTRUSTBANK uses this same list for its **Trust Rate** investments. *(The approved list of securities is available upon request.)*

Trust Rate®

The INTRUSTBANK guarantees a net return on our investors' dollars of 2% *in excess* of the average 91-day Treasury Bill weekly auction rate. *(Using the chart below, check the Tuesday newspaper business section to track your Trust Rate investment through the quarter.)*

Under the Trust Rate Program, withdrawals may be made *at anytime* after the end of the first quarter of investment. **Trust Rate** investments are fully guaranteed by the U.S. Government.

To learn more about this quality investment opportunity, contact one of our investment officers.

First Independent Trust Company
1020 12th Street
Sacramento, California 95814
916/441-3031

91-Day Treasury Bill Rates

Date	Discount Rate	Accumulative Average	Trust Rate + 2%
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /			
/ /		***Trust Rate*** =	

Current quarter figures available on request.

NEWSTALK 15

LIVE COPY

LENGTH:________ ____________

START DATE:________________

END DATE:________________

FIVE YEARS AGO, FIRST INDEPENDENT TRUST, INTRODUCED TRUST RATE, AND THROUGH THE YEARS TRUST RATE HAS CONSISTENTLY BEEN THE HIGHEST YIELDING, TOTALLY LIQUID SAVINGS ACCOUNT IN SACRAMENTO. WELL, THEY HAVE DONE IT AGAIN! FIRST INDEPENDENT TRUST IS NOW OFFERING A COMPLETE AND PERSONALIZED FINANCIAL COUNSELING SERVICE....AND IT'S DESIGNED TO BENEFIT EVERYONE. WHAT MAKES THEIR SERVICE SO UNIQUE, IS THEIR OBJECTIVITY. THEY SELL ONLY FINANCIAL COUNSELING, NOT INSURANCE, STOCKS AND BONDS OR LIMITED PARTNERSHIPS. FIRST INDEPENDENT TRUST WILL HELP YOU TO ANALYZE YOUR CURRENT

:30 FINANCIAL POLITION AND EVALUATE YOUR FUTURE GOALS AND OBJECTIV

YOU WILL THEN RECEIVE A COMPREHENSIVE FINANCIAL STRATEGY DESIGNED SPECIFICALLY TO MEET YOUR GOALS. AFTER YOU HAVE REVIEWED AND FULLY UNDERSTAND THE PLAN, YOUR PERSONAL COUNSEL WILL HELP YOU IMPLEMENT "THE STRATEGY" THAT WILL INSURE YOUR FINANCIAL FUTURE. FIRST INDEPENDENT TRUST IS A STATE CHARTER BANK, CELEBRATING THEIR 10th YEAR OF SERVICE TO NORTHERN CALIFORNIA. THEIR PERSONALIZED FINANCIAL COUNSELING WILL BENEFIT EVERYONE. A SUCCESSFUL FINANCIAL FUTURE BELONGS TO

:50 THOSE WHO HAVE A PLAN! START YOURS TODAY: CALL 441-3031.

FIRST INDEPENDENT TRUST . 441-3031

Transcript of Radio Advertisement

(Station KXOA, Sacramento. September 5, 1983)

First Independent Trust is offering a challenge. We've told you that First Independent Trust has a savings account called trust rate. That trust rate is liquid and fully guaranteed both principal and interest by the U.S. Government. That First Independent Trust is a state-chartered bank with trust banking powers which means that your money is in the safest banking institution in California. The challenge to you is to try to find a higher interest rate on a liquid savings account in Sacramento. Check all the newspaper ads. Listen to all the radio and television commercials. You will discover that no other bank or savings and loan will pay a higher rate on a savings account than First Independent Trust, the safest bank for your savings dollar. Call today to open your trust rate savings account. Call 441-3031. For your convenience, you may deposit by mail and withdraw part or all of your savings with just one phone call, 441-3031. Trust rate is currently yielding over 9.25 percent and is fully liquid. Find out how your savings can earn more. First Independent Trust -- 441-3031.

Transcript of Television Advertisement

Boss:
Gentlemen, we need to put our company funds where they'll be safe, yield a high return and be totally liquid. Suggestions?

Man:
Safe? Put the dough in a cigar box!

Lady:
High returns? How about a chain of beauty parlors!

Hanley:
A trust rate account?

All:
What?

Hanley:
A trust rate account! At First Independent Trust. The bank that offers high return, safety of the U.S. Government, and liquidity.

Boss:
A trust rate account at First Independent Trust. Hanley, I like that! As for you two, how's your typing skills?

Display at the End of Television Advertisement

Current Yield
9.66%
Full faith and credit is safer than F.D.I.C.

Poster in Television Advertisement

TRUST RATE

FIRST INDEPENDENT TRUST

1. 2% over the average quarterly T-Bill
2. Guaranteed by the full faith and credit of the U.S. Government
3. Withdraw at any time

TRUST RATE ACCOUNT

As an investor, you expect the best return on your money with the least amount of risk and few complicated requirements. Now you can have the unique combination of high return, security, and liquidity with First Independent Trust Company's TRUST RATE Account.

Safety

Safety - In these uncertain economic times, safety should be the cornerstone of every sound savings and investment program. Safety means having your money in a secure place where you don't have to worry about it.

At First Independent Trust our goal is to meet this investment objective of safety and that's why we call our account Trust Rate.

Money market funds invest in certificates of deposit from banks and savings and loans, or corporate debt. They are promises to pay I.O.U.'s.

At First Independent Trust we take a different point of view. We invest in direct government obligations which are backed by the direct full faith and credit pledge of the U. S. Government. This means that the full power of the government stands behind its promise to pay no matter what happens in the money and credit markets. That's the only kind of security we accept for our Trust Rate Account.

Insurance

Insurance - F.D.I.C. and F.S.L.I.C. "insurance" is a pool of about 18 billion backing over 1.5 trillion dollars on deposit in banks and savings and loans. Where is this pool of money invested? In government back obligations guaranteed by the full faith and credit pledge of the U. S. Government.

Trust Rate accounts are invested only with the safest securities possible, guaranteed by the full faith and credit of the U. S. Government, as are the monies with the F.D.I.C. and F.S.L.I.C. for your insurance. First Independent is a state chartered bank regulated by the state banking laws and we have insurance coverage for fraud, errors and ommissions.

In keeping with the unique safety of a trust, it is to be noted that traditional bankruptcy practices have no affect on the asset of a trust and as such those assets are not subject to seizure and distribution.

Liquidity

Liquidity is the other side of the safety coin. How safe can you feel about your money if you can't get it when you want it? Trust Rate Accounts are invested only in U. S. Treasury backed obligations, not only for their safety, but their liquidity too. No matter what conditions are in the money markets, there is always a ready market for Trust Rate.

You can withdraw money without penalty from your Trust Rate Account in several convenient ways. Phone us - we will mail a check: or we will have a check ready for you to pick-up. Stop-in - and request a check. Write a letter - and request an amount to be mailed.

Yield

Yield is closely related to risk, high returns on investments usually mean more risk. Our objective with Trust Rate is to deliver the best possible return consistent with our safety first investment policy.

Trust Rate offers an interest rate calculated by averaging the 13 week Treasury Bills over the period of one quarter. Then Trust Rate pays a yield of 1.5% to 2%, depending upon the size of the account, above that interest rate. Since 1980, Trust Rate has consistently been the highest paying money market savings account available in Sacramento.

FIRST INDEPENDENT TRUST COMPANY
1020 12TH STREET
SACRAMENTO, CALIFORNIA 95814

"CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM"

Date of Review: February 27, 1981

Persons Contacted:
Deno Evangelista, President
Jerry D. Todd, Vice-President
Walt Bishop, Trust Administrator
Theresa L. Sandoval, Accountant

Number of Files Reviewed: 11

Number of Loans Reviewed: 11

AREA OF CONCERN: INSURANCE PREMIUM ACCOUNT

1. Observation: During the review, we noted that the insurance premiums of $12,842.77 had not been paid.

However, while we were on site, a check of $12,842.77 dated February 27, 1981 was prepared and sent to the California Student Aid Commission.

Please see Section IV.4.3.5. of the California Guaranteed Student Loan Program manual for the procedure for remitting insurance premiums.

AREA OF CONCERN: REFUND

2. Observation: During the review of Mr. [redacted] file, we noted that a refund of $200 from the Academy of Business was not credited to the student's account which would have reduced the outstanding balance of the loan.

However, while on site, the student's outstanding loan balance was reduced by $200.

Vernon Gomes
Lender Examiner
Guarantee Agency and
Lender Review Branch
Division of Certification
and Program Review

APPENDIX "H"

STATEMENT BEFORE
THE U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

BY

RICHARD PULP

EXECUTIVE VICE PRESIDENT, BANK OF AMERICA NT&SA

September 25, 1990

GPS

I. INTRODUCTION

Mr. Chairman and Members of the Subcommittee:

My name is Richard Fulp. I am an Executive Vice President of Bank of America NT&SA and head of the Bank's Trust and Financial Management Services Division.

I am pleased to appear before the Subcommittee today to provide Bank of America's perspective on problems in the student loan program. Bank of America, through its lending activities, has actively supported the student loan program for three decades. As an originating lender of student loans, Bank of America is the largest lender in California and one of the largest in the nation. Last year, Bank of America originated 30% of the student loans made in California. The Bank has lent over $1 billion to students in the past 8 years and as of the end of 1989 had an outstanding portfolio of over $450 million. Bank of America's long record of commitment to the loan program is an unblemished one.

But Bank of America's efforts as an originating lender of student loans are not the reason for its testimony here today.[1] In addition to acting as an originating lender, Bank of America has also acted in another capacity in the student loan program. In the early 1980s, the California Student Loan Finance Corporation (CSLFC) selected Bank of America to act as indenture trustee for CSLFC's secondary market for student loans. This secondary market eventually grew to become the second largest secondary market in the country.

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[1] The Subcommittee has asked Bank of America to provide a statement of its views on the student loan program in its capacity as originating lender. That statement is found in Appendix A.

As the Members of the Subcommittee are aware, the secondary market managed by CSLFC has experienced significant problems over the past two years. These problems, which have received national media attention, are due to a variety of factors -- some affecting the student loan program nationally and others more specific to the California market. As many of you may know, these problems have resulted in an unprecedented and unfounded lawsuit filed against Bank of America by ten of the world's largest banks, most of them foreign, which provided letters of credit to support CSLFC's financings. These banks are seeking to impose on Bank of America, retrospectively, duties and responsibilities it simply does not have and to hold Bank of America, as indenture trustee for the CSLFC secondary market, liable for the various problems.

I am here today at the request of the Subcommittee to discuss various issues and questions you have asked me to address. Much of the information I will share with the Subcommittee today Bank of America has learned only recently, through work performed outside of its normal role as trustee.

At the outset, however, the Members of the Subcommittee should understand that the experience in California is not unique. The problems I will describe are in large part the result of pressures affecting the student loan program nationally -- including rising default rates; a growing concentration in loans to students attending trade schools, who tend to default in disproportionately large numbers; increasingly complex and burdensome loan servicing requirements by the Department of Education and the guarantee agencies, with excessive penalties for non-compliance; abuses by some originating lenders and at loan servicers; and, most recently, the financial difficulties faced by HEAF, the nation's largest guarantor.

The combined effects of these factors have manifested themselves in California in three highly-publicized ways:

(1) the abusive lending practices by the First Independent Trust Company (FITCO) and its subsequent insolvency;

(2) the servicing failures at United Education & Software (UES), the major servicer of loans for CSLFC; and

(3) the potential impact on the California market of HEAF's financial crisis.

As I will explain in more detail, Bank of America did not create any of these problems. Rather, Bank of America has already been a victim of the problems at UES and FITCO. Moreover, Bank of America is concerned that HEAF's financial crisis may make the situation worse, unless the Department of Education succeeds in resolving the crisis promptly, in a way that treats all lenders equally. The CSLFC secondary market participants -- all private, not public entities -- face hundreds of millions of dollars in losses as a result of these problems. Together, these difficulties have substantially closed the nation's second largest secondary market for student loans for over two years.

II. THE CSLFC SECONDARY MARKET

Before explaining the various problems affecting the CSLFC portfolio, it is important that the Members of the Subcommittee understand how a secondary market for student loans works.

There are several secondary markets for student loans operating around the country. The largest is run by Sallie Mae, while CSLFC runs the second largest. Generally speaking, secondary markets serve to raise private capital for financing student loan acquisitions, usually through issuing debt securities to the public. The funds raised through these offerings are then used to purchase student loans from originating lenders who have made loans to students. A secondary market thus indirectly supports originating lenders by providing an available outlet to sell loans they make.

A. Loan Origination

The first stage in the lending process is the loan origination phase. The student, often with the assistance of financial aid officers at the school, prepares a loan application and submits it to a lender. To qualify for a guaranteed student loan, a student must be enrolled in a school that is eligible to participate in the loan program.

For a school to be eligible, it must meet the criteria established by the Department of Education and enter into a program participation agreement with the Department. Before entering into such an agreement, the Department must determine that a school is licensed by the relevant state licensing board, is accredited by a body recognized by the Department, and is financially sound. After the school is initially approved, it must be recertified by the Department every four years. Once a school becomes eligible to participate in the program, it remains eligible unless the Department denies recertification or institutes an administrative proceeding to terminate the school's participation. In addition, each guarantee agency is required to audit the ten largest schools in its portfolio to ensure compliance with federal standards, and may initiate its own proceeding to terminate the eligibility of a school for loans it guarantees.

Originating lenders, also, must meet federal criteria and qualify as "eligible lenders" under the Higher Education Act and the Department's regulations. Eligible lenders must enter into an agreement with the Department for participation in the loan program. In addition, a lender must be approved by a guarantee agency and execute a lender agreement with the agency as a precondition for making guaranteed student loans. As is the case with schools, guarantee agencies have duties under federal law to audit the ten largest lenders in their portfolios to ensure that they comply with program requirements.

After a student enrolled in an eligible school submits a loan application to an eligible lender, two things must happen before the loan is made. First, the lender must approve the student's application. The lender is not required, though, to review the student's creditworthiness or impose any other credit standards. Rather, it is the fundamental premise of the program that the creditworthiness of students does not determine whether they get loans -- if a student meets the eligibility criteria set forth in the Higher Education Act and the regulations, the loan is made.

Second, the guarantee agency must issue a guarantee on the loan. Each loan must be individually accepted by the guarantee agency. In exchange for issuing a guarantee, the agency is paid a guarantee fee.

After the lender approves the loan and the guarantee agency issues the guarantee, the loan is made. The funds are disbursed to pay for the student's educational expenses, after the Department's origination fee and the guarantee agency's guarantee fee are deducted. The first stage in the life cycle of the student loan, which is essentially the same whether the loan will be retained by the originating lender or sold to a secondary market, is complete. To the best of my knowledge, all CSLFC loans were made by originating lenders who were eligible lenders and made to students enrolled in schools that were eligible schools.

B. Acquisition By the Secondary Market.

During the initial, loan origination phase, the secondary market in general and Bank of America as trustee in particular have no direct involvement. After the loan is originated the secondary market comes into play. The secondary market maker handles the arrangements with the originating lenders for the purchase of student loans. In exchange for an agreed upon price, the originating lender transfers its rights in the loans to the secondary market maker.

In California, the major secondary market is managed and directed by CSLFC. CSLFC had the contacts with the originating lenders, identified the particular groups of loans to be purchased, and negotiated over the price and other terms of the purchase.

To raise funds for its purchases, CSLFC issued several series of debt securities or bonds. Each series of bonds was issued under the terms of an indenture of trust between CSLFC as the issuer of the bonds and Bank of America as trustee for the benefit of the purchasers of the bonds.[2] The indenture agreements govern the rights and duties of the various participants.

CSLFC's bonds are supported by the student loans purchased on behalf of CSLFC. Payments on the student loans received from borrowers, default payments received from guarantee agencies when borrowers default on the loans, and federal interest subsidies provide funds to pay principal and interest to bondholders and cover the other expenses of the indenture estates. In addition, to further guarantee principal and interest payments to bondholders, CSLFC obtained letters of credit from various banks. The letters of credit are drawn upon to cover payments to bondholders, and the letter of credit banks are reimbursed as funds are available from other sources such as borrower repayments or default claim payments. If other funds never become available to the indentures, the letter of credit banks incur unreimbursed losses on the letters of credit. The letter of credit banks are paid fees based in part on the size of their letters of credit; these fees approach, and in some cases exceed, $1 million per year for each of the CSLFC indenture estates.

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[2] Each of CSLFC's active indentures and bond issues is listed on Appendix B.

These letters of credit are critical to the operation of the secondary market. Without the financial backing they provide, CSLFC could not as a practical matter raise funds for student loan acquisitions. CSLFC obtained the letters of credit from several of the largest banks in the world, primarily Japanese banks. (See Appendix B.) During the 1980s, these banks aggressively entered the American market and came to dominate it. They provided letters of credit for most of the student loan secondary market financings in this country.

Together, CSLFC and the letter of credit banks executed 23 financings between 1982 and 1988, raising close to $2 billion.

CSLFC selected Bank of America to act as trustee for the indentures. Bank of America receives a fee for serving as indenture trustee, equal to, on average, approximately $35,000 per year for each indenture. Its duties, as defined in the relevant agreements, are typical of the duties of other secondary market trustees. The Bank's duties involve, primarily, accounting for the monies of the indentures -- receiving funds due the indentures and expending funds as directed by CSLFC. For example, the Bank:

- receives the proceeds from the bond issues and applies such proceeds as directed in the applicable indenture agreements;
- receives from the loan servicer funds received in connection with the student loans, including loan payments by students, default claim payments by guarantee agencies, and federal interest subsidies;
- pays administrative expenses from funds available in appropriate indenture accounts as directed by CSLFC;
- makes principal and interest payments to bondholders as they come due;
- draws on letters of credit to make timely payments to bondholders.

Because CSLFC does not qualify under the Higher Education Act as an eligible lender permitted to hold guaranteed student loans, Bank of America serves as eligible lender holding title to the student loans on behalf of CSLFC. This arrangement, with Bank of America holding nominal legal title to the loans for the benefit of CSLFC, has been approved by the Department of Education as permissible under the Higher Education Act.

When CSLFC decides to purchase student loans, it directs Bank of America as trustee to execute that purchase through written purchase instructions. As part of the process, the originating lender selling the loans to CSLFC provides written warranties that the loans qualify in all respects for guarantee coverage and federal reinsurance. Once Bank of America receives the written purchase instructions from CSLFC and a certificate from the loan servicer that the seller has provided the proper warranties and other documentation, Bank of America implements the purchase instructions as required under the relevant agreements.

Bank of America's role as trustee under the contracts of indenture is limited in other important respects. The Bank holds nominal title to the loans, but the relevant agreements do not require it to have possession of the loan files -- the outside servicing company hired by CSLFC does that. Nor does Bank of America have any contact with the student borrowers or otherwise service the loans -- again, the outside servicing company performs these duties. Finally, it is not the role of Bank of America as trustee to deal directly with the Department of Education or the guarantee agencies regarding management of the CSLFC indentures.

C. Loan Servicing

With the structure of the secondary market in mind, let me return to the life cycle of the student loan. For most student loans, students are not obligated to make payments on the loans while they are in school. When a student finishes school and the applicable grace period expires, the next stage in the loan's life cycle begins -- the loan repayment stage. Now the student must repay the debt, usually in monthly installments. Specifically, the student is to make monthly payments to the loan servicer for the CSLFC indentures. As mentioned above, CSLFC retained outside servicing companies to service the loans in accordance with federal requirements. The largest loan servicer for the CSLFC portfolio was United Education & Software (UES), which CSLFC hired in 1982. CSLFC was responsible for overseeing the loan servicing and had authority to hire and fire the loan servicer. Periodically, when CSLFC issued new financings or refinanced the letters of credit, it issued certificates which were presented to Bank of America and others containing representations indicating that all loans were being serviced in accordance with federal requirements.

To assist in overseeing loan servicing, CSLFC hired the accounting firm of Main, Hurdman, which later merged with Peat Marwick. These auditors examined the servicing operations at UES as part of the annual audit of CSLFC. Peat Marwick provided clean audit opinions, as well as reports stating that UES's loan servicing systems and procedures were in compliance with federal requirements. These audit opinions and reports never reported a material problem at UES.

While a student is making payments on the loan, the servicer keeps track of the student, sends out monthly bills, and credits payments to the student's account. In addition, the servicer answers any inquiries from students about their loans and handles requests for loan deferments.

If a borrower misses a payment and becomes delinquent, that begins the next stage in the life cycle of a student loan -- the delinquency phase. At this point the loan servicer implements the detailed federal requirements for attempting to collect the loan from the borrower -- known as performing "due diligence" on the loans. For a 180-day period, the servicer attempts, via letters and phone calls, to bring the borrower current on the loan. The number and timing of these letters and phone calls are prescribed by the Department of Education. In addition, if a borrower's whereabouts are unknown, the servicer initiates skip-tracing and attempts to contact the borrower's references in order to locate the borrower.

If a borrower brings the loan account current, normal servicing resumes. If, however, after 180 days of due diligence the borrower is still delinquent, the loan defaults and the loan enters its final stage -- the default phase. At this point the servicer prepares a default claim to be filed with the guarantee agency within 90 days of the default.

The guarantee agency then pays the default claim. In the case of CSLFC the default claim payment is sent to the loan servicer, who forwards the money to Bank of America as trustee for the indentures. From the perspective of the secondary market, once the default claim is paid the life cycle of the loan is complete.

From the perspective of the federal government, of course, the process continues. After paying a default claim and undertaking efforts to collect the loan, the guarantee agency submits a claim for reinsurance to the Department of Education. Under federal law, guarantee agencies receive reinsurance from the Department for between 80 and 100% of the amount the guarantee agencies pay in default claims. The amount of reinsurance depends upon the annual default rate of the portfolio of loans guaranteed by the agency. If the default rate is less than 5%, the guarantee agency receives 100% reinsurance from the Department. If the agency's default rate is between 5 and 9%, it receives 90% reinsurance. If its default rate is greater than 9%, the guarantee agency receives 80% reinsurance.

III. CHARACTERISTICS OF THE CSLFC PORTFOLIO.

Before discussing the problems affecting the CSLFC loan portfolio, let me first describe its basic characteristics. The portfolio was started in 1980 and grew steadily through the 1980s. By the beginning of 1987 the portfolio held $600 million in student loans. The portfolio grew rapidly during 1987 and early 1988, reaching a peak of over $1.6 billion. Today, the portfolio totals approximately $1.1 billion.

CSLFC purchased loans from a variety of lenders both in California and elsewhere in the country. Each of these lenders qualified as an eligible lender under Department of Education regulations, and each was approved by at least one of the guarantee agencies for making guaranteed student loans.

The loans have financed education at a wide variety of post-secondary educational institutions, again both in California and elsewhere around the country. These include four-year schools, two-year schools, and trade schools. Each of these schools has been approved by the Department of Education for participation in the loan program. The largest portion of the CSLFC loans, accounting for roughly 80% of the portfolio, have gone to students attending trade schools.

The vast majority of loans in the CSLFC portfolio have been guaranteed by three guarantee agencies. The largest guarantee agency is HEAF, accounting for approximately 49% of the portfolio. The California Student Aid Commission (CSAC) guarantees approximately 45%. United Student Aid Funds (USAF) guarantees approximately 6% of the portfolio.

The loan servicers for the CSLFC portfolio currently include Mitchell Sweet & Associates (MSA) and AFSA Data Corporation. Prior to November 1988, UES was the largest loan servicer for the CSLFC portfolio, handling over $1.2 billion in loans. After the problems arose at UES, the Costa Mesa Servicing Center (CMSC), a subsidiary of AFSA, took over servicing of the loans formerly handled by UES.

IV. THE PROBLEMS AFFECTING THE CSLFC PORTFOLIO.

With these portfolio characteristics in mind, let me now turn to the specific problems affecting the CSLFC portfolio. These problems, which threaten to cost the secondary market participants hundreds of millions of dollars, revolve around three parties: FITCO, UES, and HEAF. I will address the problems relating to each of these parties in turn.

A. The FITCO Problem.

The first problem affecting the California market involves FITCO, a financial institution headquartered in Sacramento, California that qualified as an eligible lender for participating in the student loan program. FITCO made guaranteed student loans almost exclusively to students attending trade schools within California. During 1987 and early 1988 FITCO sold large numbers of its student loans to CSLFC. In fact, FITCO became the largest originating lender in CSLFC's secondary market.

As I have explained, CSLFC made the decisions on what loans to buy and what lenders to buy from. Bank of America had no dealings at all with FITCO prior to the time the problems arose. It was only after the problems arose that Bank of America learned about the FITCO practices and the resulting problems.

As the Members of the Subcommittee are aware, FITCO is currently insolvent, and since May 1989 has been under the direction of the California Superintendent of Banks as Liquidator. The problems and abuses in FITCO's lending practices have been well documented. The FITCO lending practices that are currently causing the most problems for the CSLFC indenture estates fall generally into three categories:

(1) FITCO failed to pay the loan origination fee due the Department of Education and the guarantee fee due the guarantee agencies on a large number of its student loans. When CSLFC purchased loans from FITCO, it paid FITCO for those fees and received certifications from FITCO that the proper fees had been paid. We have now learned that certain of those certifications from FITCO were false, which has jeopardized the guarantee and reinsurance coverage for some CSLFC loans.

(2) FITCO failed to report when some students left school early enough to avoid some or all of their tuition payments, with their loans being cancelled or refunded and the proceeds being returned to FITCO. Some of the loans purchased by CSLFC have been cancelled or refunded in this way, and therefore are not collectible. FITCO never informed CSLFC of some of these loan cancellations and refunds, and kept the loan proceeds instead of paying them to CSLFC.

(3) FITCO disbursed some loans to students in multiple installments and sold the disbursements individually, as if they were separate loans. While

> this practice does not violate any express federal regulations, the Department of Education has recently decided that multiple disbursements of a loan must be consolidated and treated as a single loan for servicing and other purposes.

There is no question that FITCO's practices have caused losses to the CSLFC indenture estates. CSLFC and the letter of credit banks have been negotiating with FITCO's liquidator, the California State Banking Commission, in an attempt to reconcile FITCO's accounts and resolve some of the problems caused by its lending practices.

B. The UES Problem.

The factors giving rise to the servicing problems at UES were not unique to the CSLFC secondary market, but, rather, affected the student loan industry nationwide. Indeed, the story of UES servicing failures is, in large part, the story of changing conditions and regulations affecting the entire student loan market.

Bank of America was not directly involved in this story as it was unfolding. But in the two years since the problems came to light, Bank of America has expended countless hours looking into the UES problems, both in its efforts to work out the problems and in discovery in the litigation brought by the letter of credit banks. I can thus share with you the Bank's views on how the UES problems arose and why.

1. Background of the Problem

As the Members of the Subcommittee are well aware, in the early years of the student loan program most loans went to students at two-year and four-year schools. In the mid-1980s, this pattern began to shift as an increasing volume of loans was made to students attending trade schools. Students at trade schools have historically defaulted at much higher rates than students attending four-year institutions. By the second half of the 1980s, loans to trade school students began defaulting in record numbers, sending the costs to the government of the student loan program skyrocketing.

At the same time, the Department of Education was imposing stricter due diligence requirements on lenders and loan servicers. Prior to 1987 the Department did not mandate specific due diligence requirements. The Department only required that the loan servicer perform reasonable collection activities at least as extensive as those generally practiced for the collection of consumer loans. But in March 1987 new federal regulations became effective that prescribed specific steps to be taken when a borrower misses a loan payment. Thereafter, the Department began, for the first time, strictly enforcing the technical due diligence requirements.

The student loan industry was not well-prepared for these inflexible standards and was ill-equipped to handle the additional workload they created. Many loan servicers had difficulties complying with all the technical requirements. The penalty for noncompliance was harsh -- the federal regulations provide that federal reinsurance is lost if any of the prescribed due diligence steps is missed. Once federal reinsurance is lost, the guarantee agency will not pay the lender when a loan defaults. Thus, the failure to make a single phone call or send a single letter could result in the loss of the guarantee on the student loan. In late 1987, these regulations resulted in a flood of default claim rejections by guarantee agencies, which fueled complaints in the industry that the new federal requirements were draconian. In response, in early 1988 the Department adopted "cure" procedures by which due diligence violations could be remedied and the guarantee on the loan could be restored. The cure procedures vary depending on the number and type of violations, but commonly require that the servicer locate the borrower and/or that the borrower make a full installment payment or sign a new repayment agreement. Such cures are very difficult to obtain in many circumstances, particularly in cases where the borrower has had a poor educational experience and/or has no employment income or other assets with which to repay the loan.

The net result of this system -- strict due diligence standards, loss of the guarantee and reinsurance if technical requirements are missed, and difficult cure procedures that are often unsuccessful -- is to shift to the holders of loans a portion of the default risk inherent in the student loan program. Whenever a due diligence requirement is violated and cannot be cured, the holder of the loan absorbs the loss, even if the student would have defaulted under any circumstances. With respect to borrowers who would have defaulted even if all of the due diligence requirements had been met, it is fair to say that the credit risk on the loan, which the government accepted as the fundamental premise of the loan program, is shifted to the holder of the loan. With the guarantee lost, the holder must try to collect the defaulted debt from the borrowers themselves -- which often proves impossible.

2. The UES Servicing Failures

This was the environment in which the UES servicing difficulties arose. By late 1987, these changing conditions in the student loan program were putting a severe strain upon UES's capabilities to adequately service student loans. In particular:

a) The portfolio of loans UES was servicing nearly doubled during 1987 and early 1988 to $1.2 billion; this meant UES had to service an ever-increasing number of student loans.

b) The portfolio was becoming more mature and a growing percentage of the student borrowers were leaving school, having their loans come due, and becoming delinquent.

c) The portfolio was highly concentrated in trade school loans; the disproportionate delinquency and default rate of these loans drastically increased the amount of collection activities UES had to perform.

d) The new federal regulations further increased the level and complexity of collection activities required at UES.

In the face of these growing pressures, UES experienced a breakdown of its servicing operations. UES simply could not keep up with its workload. On a significant number of loans UES failed to perform all the prescribed due diligence. These problems were exacerbated by both a relocation to new premises and a computer conversion UES attempted, on its own, in 1987 in an effort to expand its capabilities to keep pace with increasing demands. UES experienced numerous problems with the attempted conversion, which, in the end, proved to be an enormous technical disaster. The net result of the failed computer conversion was a substantial pollution of UES's database, which made it impossible to determine accurately the status of many loans and what due diligence steps were required. This added to the burden of an already overloaded staff at UES. The company was forced to hire new workers, some of whom proved less than competent.

The result of all these factors was a serious breakdown in UES's servicing activities that affected a sizable portion of the CSLFC portfolio.

3. Bank of America's Response

In June of 1988 the Department of Education, together with HEAF, conducted a review of UES's activities. In July the Department disclosed the preliminary results of that review to CSLFC and began working with CSLFC to remedy the problems uncovered. In late July, Bank of America was notified of the problems. This was the first indication to Bank of America of the UES servicing failure and, in fact, the first time the Department or the guarantee agencies had contacted Bank of America for any reason concerning the CSLFC portfolio. Other parties including CSLFC, the auditors from Peat, Marwick, HEAF and the other guarantee agencies, and the Department of Education all were made aware of questionable servicing activities at UES before Bank of America was.

The Department's report issued in August 1988 claimed serious deficiencies in the UES loan servicing operations. The deficiencies described by the Department included failure to send due diligence letters and make due diligence phone calls; failure to process student status changes; documents missing from files due to a huge backlog of filing; insufficient staffing to perform collection activities; and other related problems.

After Bank of America was informed of the UES problems, it took steps to protect the assets of the indentures and minimize the losses that UES's failures would cause. Bank of America determined, and the other parties to the indentures agreed, that UES could not adequately remedy the problems it had caused or continue to service the CSLFC portfolio. The Department concurred in the opinion that UES had to be removed as loan servicer. Bank of America, CSLFC, and the other parties took steps to replace UES in order to ensure that the loans in the CSLFC portfolio were properly serviced. UES was removed as loan servicer and replaced by CMSC, a subsidiary of the experienced AFSA group. UES's servicing operations were liquidated; and UES is no longer in the loan servicing business.

As part of the efforts of Bank of America and the other parties to remedy the UES problems, Bank of America conducted technical testing of the UES database. As this testing progressed, Bank of America found two computer programs developed by UES, known as FIX and COMFIX, that appeared designed to insert false entries of due diligence activities into the loan collection histories. Further testing confirmed that the programs were run during a one-week period in October 1987. Bank of America immediately reported this finding to the Department. The Bank has now identified the loans affected by these computer programs. For over 4,000 of the affected loans, equal to approximately $11 million in principal, default claims had been paid before the suspect computer programs were uncovered; these loans are being repurchased from the guarantee agencies.

Bank of America continues to work with CSLFC, the new servicer, the letter of credit banks, and the Department of Education to minimize the harm done to the CSLFC indentures. All the parties to the CSLFC indentures have agreed, pursuant to a restructured relationship among themselves, that Bank of America, along with CSLFC and a representative of the letter of credit banks, should serve on a servicing oversight committee. This new committee has created a structure for overseeing the loan servicing operations and has guided the on-going efforts of the new servicer to resolve the problems created by UES.

4. The Costs to the Indenture Estates

Despite the efforts of Bank of America and the other parties, the UES servicing problems have created huge costs for the CSLFC indenture estates. When the problems first came to light in July 1988, the Department of Education suspended default payment on all CSLFC claims. It was not until December 1989, nearly 18 months later, that the Department was able to sort out the servicing issues and authorize a resumption of default payments on eligible CSLFC loans. This lengthy delay proved extremely costly for the indenture estates. For a year and a half, they received no funds from default claim payments on loans serviced by UES. The interest losses on these funds alone was enormous. Moreover, without this money coming in, certain of the indenture estates have been forced to draw upon the letters of credit to pay expenses and have not received sufficient funds to reimburse the letter of credit banks. One of the letter of credit banks alone has already incurred more than $170 million in unreimbursed draws.

When the Department of Education did make its final determination on the eligibility of UES-serviced loans for guarantee and reinsurance, its response was harsh in two important respects.

First, the Department took the blanket position that all due diligence activities by UES would be presumed invalid. Thus, any loan serviced by UES that required due diligence collection activities became ineligible for reinsurance. The Department agreed to restore reinsurance only if these loans were cured in accordance with established cure procedures. While the Department certainly has an interest in ensuring that the taxpayers suffer no loss as a result of the UES problems, it is now clear that the Department's actions went far beyond this: they have gained for the government and the guarantee agencies a windfall in excess of

$200 million, by denying reinsurance even on loans that would have defaulted in the absence of any servicing problems. The Department's course of action has served to shift a large portion of the default risk inherent in the government's loan program away from the government and to the private parties to the CSLFC indenture estates. Bank of America and the letter of credit banks have consistently expressed its opposition to these decisions by the Department.

Second, the Department of Education imposed an additional penalty for loans affected by the two suspect UES computer programs. The Department has denied reinsurance irrevocably on loans touched by these programs, regardless of whether the programs affected the creditworthiness or collectability of the loan, regardless of whether the computer programs had any effect on proper servicing of the loan, and regardless of whether the false entry created by the computer programs was corrected before the loan was submitted for default claim payment. The Department went so far as to deny reinsurance irrevocably on loans that did not exist at the time the suspect computer programs were run, if the borrower had other student loans that were touched by the UES programs. What is worse, the Department has imposed this penalty not on UES, who committed the wrongdoing, but rather on the innocent parties to the indenture estates -- who undeniably had no knowledge of the UES computer programs at the time they were run. It is undisputed that these parties, including Bank of America, were in no way involved in any of the intentional wrongdoing at UES; in fact, it was Bank of America who discovered the computer programs and reported them to the Department. Yet the indenture estates are not only paying for the actual costs of the UES servicing problems but also paying an additional penalty totalling millions of dollars. Bank of America believes the Department's action on this issue is unfair and contrary to established legal principles and has so informed the Department.

The UES problems and the response of the Department of Education have had an enormous, adverse impact on the CSLFC indenture estates. The servicing failures and the Department's harsh response may cost the indenture estates hundreds of millions of dollars. And these already enormous losses may be magnified by HEAF's current financial crisis -- the problem to which I now turn.

C. The HEAF Problem

HEAF is the guarantor for approximately $560 million in CSLFC student loans, and over $9 billion in student loans nationwide. Its current problems pose a threat to the integrity of the entire loan program.

The causes of HEAF's current difficulties have been well-publicized and I will only briefly comment on them. In the mid-1980's, the annual volume of student loans guaranteed by HEAF grew dramatically, from less than $900 million in 1984 to nearly $3.3 billion by 1988. By 1988 HEAF was the nation's largest guarantor, accounting for 27 percent of the student loan guarantees issued in the country that year.

This dramatic growth in HEAF's loan volume included a large volume of loans to trade school students. From 1986 through 1988, well over half the loan guarantees issued by HEAF were for trade school students. This portfolio mix began to cause problems for HEAF, as its portfolio of trade school loans began defaulting in huge numbers. As I explained above, the amount of reinsurance a guarantee agency receives from the federal government on default claims paid to lenders depends upon the guarantee agency's default rate. Because of the large proportion of trade schools in its portfolio, HEAF's default rate has been extremely high. For a significant portion of its portfolio, HEAF has been receiving only 80 percent reinsurance from the government. Therefore, HEAF itself has been taking a 20 percent loss on default claims it pays to lenders.

Over the past two years, HEAF has suffered large losses in unreinsured default claim payments. HEAF now apparently lacks the short-term cash flow and the long-term financial stability to absorb these unreinsured default claim payments.

These developments have placed in jeopardy HEAF's guarantee on over $300 million in CSLFC loans. As a result of its current crisis, HEAF has essentially stopped processing all default claims on CSLFC loans, even with respect to loans the Department of Education has agreed are eligible under federal guidelines. Thus HEAF has saved money on the CSLFC portfolio both through not paying eligible default claims and through the windfall I have described above resulting from the Department's decisions on the UES servicing issues.

As you would expect, Bank of America and the other parties to the CSLFC indenture estates are monitoring closely the Department of Education's intensive efforts to resolve the HEAF crisis. The Department has assured Bank of America that it will, in the near future, develop a solution that preserves the integrity of the HEAF guarantee and treats all participants in the program equitably. I am optimistic that the Department will be able to fulfill these pledges. It need hardly be said that a failure to do so would impose enormous additional losses on the CSLFC indenture estates and critically damage the entire student loan program.

V. CONCLUSION

Bank of America is encouraged to see that the Congress and the Department of Education are closely reviewing the student loan program. The current scrutiny can only result in a stronger, more stable program. As the Members of this Subcommittee grapple with these issues and develop recommendations, I urge you to bear in mind the important role played by secondary markets like the one managed by CSLFC. Unfortunately, in the current environment there is a risk that the private secondary markets for student loans will shrink. The rising costs and uncertainties in the program may scare off the financial institutions that are necessary for secondary markets to function. In the face of increasingly stringent servicing requirements, with harsh penalties for non-compliance, and the particularly harsh response of the Department to servicing problems of the sort that arose at UES, lenders, issuers, and letter of credit banks may be forced to re-examine the extent of their commitment and exposure to student lending.

We have already seen some evidence of this. The CSLFC secondary market -- the nation's second largest -- has bought only minimal amounts of student loans over the past two years. Other secondary markets around the country have experienced difficulties in obtaining letters of credit to support student loan financings. If these trends continue, the result may be an erosion of private funds available for student loans, which would make it more difficult for students to finance their educational opportunities. Bank of America shares the Subcommittee's hope that these possibilities do not materialize and that private financial institutions around the country remain vigorously committed to the student loan program.

Mr. Chairman, that concludes my statement. I thank you for the opportunity to present Bank of America's views on these issues.

Appendix A

to Statement of Richard Fulp,

Executive Vice President, Bank of America NT&SA

BANK OF AMERICA'S ROLE AS ORIGINATING LENDER

In addition to serving as trustee for the CSLFC secondary market, Bank of America also acts as an originating lender in its own right. Bank of America has been asked by the Subcommittee to share some of its views on the student loan program from this perspective as originating lender. This Appendix responds to that request.

Bank of America is the largest originating lender of student loans in California, and one of the largest in the nation. Last year, Bank of America originated over 30% of the student loans made in California. The Bank has lent over $1 billion to students over the past eight years and as of the end of 1989 had an outstanding portfolio of over $450 million.

Bank of America expects to remain an important player in the student loan origination business. The Bank remains firmly committed to the program, in part for economic reasons, but also because Bank of America recognizes that educational funding is important to the communities the Bank serves.

However, changing conditions in the student loan program over the last several years have significantly increased the risks of lending to student borrowers. Specifically, the risks that lenders face include:

> (1) The risk of unacceptably high default rates on student loan portfolios, which is principally a problem associated with high levels of lending to trade school students. High default rates can cost lenders money, because loans that default are less profitable than loans that are fully repaid, due to higher administrative and servicing costs.
>
> (2) The risk of loan servicing problems, which jeopardize the guarantee on the loan.
>
> (3) The risk of guarantee agency insolvency.

Bank of America, like other lenders in the program, has taken several steps to alter its lending policies to protect itself against these risks.

Default Risk

To reduce the risk of high default rates associated with loans to trade school students, Bank of America has begun to manage more actively its portfolio of student loans and to reduce the proportion of trade school loans it makes. Prior to 1989, Bank of America and other lenders generally relied on the Department's school certification process as the principal criteria for a school's participation in the Bank's lending program. Generally speaking, most lenders would make loans to students attending any school certified by the Department as an eligible institution.

It has become apparent recently that the certification process, and in particular the school accreditation procedures upon which it relies, do not assure that all eligible institutions will provide quality education. Poor quality schools, and in some cases abusive practices, have contributed to high default rates and other lending problems. For these reasons, Bank of America has implemented its own standards that schools must meet before Bank of America will make loans to their students. The Bank itself monitors the default experience of loans made to students at trade schools, to avoid making loans to students attending schools that present the greatest risk of default. Bank of America's lending standards now require, for example, that the default rate of students attending a participating school be below identified levels. Schools that cannot meet those standards have been excluded from Bank of America's loan program.

With these new standards in place, Bank of America continues making loans to trade school students -- though in smaller numbers than before. Last year, approximately one in four loans originated by the Bank went to trade school students. Even with these new standards, however, Bank of America's costs on trade school loans exceed the interest revenues. As a community service, the Bank expects nonetheless to continue its commitment to funding trade school education. However, certainly significant changes in the loan program that Congress or the Department may enact could cause Bank of America, as well as other lenders, to again re-examine their lending practices in this area.

Servicing Risk

Bank of America's practice is to sell in the secondary market a substantial portion of the loans it makes. Currently, Bank of America retains approximately one quarter of the loans it originates, specifically, those with high principal balances. Because most of the loans Bank of America sells are sold before the student's repayment obligations begin (i.e., while the student is in school or in grace status), the risk of a servicing problem affecting guarantee or reinsurance coverage on Bank of America's portfolio is substantially reduced. Sallie Mae is the principal purchaser of the loans Bank of America sells.

Guarantee Agency Insolvency Risk

Bank of America, as an originating lender, faces the risk that the guarantee agencies with whom it does business may become financially insolvent. This risk has been highlighted recently, as a result of HEAF's financial crisis and the Department's stated position that it has no legal obligation to back the guarantees made on student loans by guarantee agencies. These developments will force lenders to scrutinize the financial condition of the guarantee agencies very closely. While Bank of America has no current concerns about the financial stability of the guarantee agencies that guarantee the bulk of its student loan portfolio, the solvency of guarantee agencies is clearly one of the major risks of lender participation in the student loan program. Lenders do not have effective ways to protect themselves from this risk, other than directing their new business away from guarantee agencies as soon as early signs of potential financial problems occur. And such steps would not eliminate the problem for loans previously guaranteed.

Bank of America believes that the nation's commitment to supporting student education is an important one. We will continue to support the federally guaranteed student loan program through these difficult times. However, to the extent that Congress and the Department of Education can correct the problems currently facing the program, lenders will be in a better position to continue their existing level of support for educational lending. In this regard, Congress and the Department of Education should consider ways to reduce the default rates among borrowers, particularly trade school students, and to ensure the viability and stability of both secondary markets and guarantee agencies.

APPENDIX B

CSLFC ACTIVE INDENTURES

Closing Date	Series	LC Bank
July 15, 1982	1982A	Dai-Ichi Kangyo
April 1, 1984	1984B	Citibank Sumitomo
March 1, 1985	1985B	Dai-Ichi Kangyo
October 1, 1985	1985C	Fuji
November 1, 1985	1985D	Dai-Ichi Kangyo Mitsubishi Trust Sumitomo Trust
December 1, 1985	1985E	Bank Of Tokyo
December 1, 1985	1985F	Dai-Ichi Kangyo Sanwa
December 1, 1985	1985G	Mitsubishi Trust
July 1, 1986	1986A	Industrial Bank of Japan
July 1, 1986	1986B	Fuji Bank
August 1, 1986	1986C	Dai-Ichi Kangyo Rabobank
June 1, 1987	1987A	Sumitomo Trust
August 1, 1987	1987B	Mitsubishi Bank
November 1, 1987	1987C	Mitsubishi Bank
March 1, 1988	1988A	Dai-Ichi Kangyo

Answers to Follow-Up Questions Presented by Subcommittee Staff

November 13, 1990

by

RICHARD FULP
Executive Vice President, Bank of America NT&SA

Introductory Statement: I have received the follow-up questions enclosed with Eleanore J. Hills's October 19, 1990 letter. Many of the questions seek information outside my personal knowledge. I have contacted persons at Bank of America to obtain the information requested and am relying on such information in providing the answers below.

1. Question: Does the Bank of America act as trustee for other student loan secondary markets?

   Answer: No.

2. Question: Did the Department of Education specifically endorse or approve the Bank of America/CSLFC arrangement? Do you have any documents pertaining to this approval?

   Answer: Before CSLFC began making a secondary market for student loans, the Department had approved a secondary market arrangement in Texas whereby a trustee acted as eligible lender and held legal title to the student loans. At the time of CSLFC's first student loan financing in 1981, counsel working on the transaction sent a letter to the Department of Education enclosing a copy of CSLFC's plan for doing business and indicating that CSLFC planned to follow the Texas model. The Department expressly approved this structure. See letter dated September 30, 1981 from H. J. Raffensperger to Jay S. Olins (copy attached hereto). Thereafter, the Department was informed that the same structure would be followed for each subsequent CSLFC financing.

3. Question: In your written statement, you testified that Bank of America received and accounted for funds from loan payments by students, default claim payments by guarantee agencies, and federal interest subsidies. Did Bank of America physically do all of this? If not, was the bank responsible for all of this?

Answer: Bank of America does not, in the first instance, receive all of these payments. Loan payments from students and default claim payments from guarantee agencies are received initially by the loan servicer. The loan servicer forwards the proper amounts to Bank of America as trustee. It is the job of Bank of America as trustee to account for the funds received and deposit them in the correct indenture account.

4. Question: It was brought to our attention that the portfolio experienced a major problem because First Independent Trust Company sold partial loan disbursements as single loans. Please explain this.

Answer: It is correct that First Independent Trust Company ("FITCO") sold partial loan disbursements individually, as if they were separate loans. Although this practice does not violate any express federal regulations, the Department of Education has recently decided that such multiple disbursements of a loan are not eligible for federal reinsurance unless they are consolidated and treated as a single loan for servicing and other purposes. This has created administrative costs for the indentures and the risk of loss of reinsurance on some loans that cannot be consolidated.

5. Question: How do you handle defaulted loans in the bond portfolios? Are they and other problem loans replaced in each bond?

Answer: CSLFC continues to carry defaulted loans as an asset in the bond portfolios as long as they are guaranteed. When a guarantee payment is received for a defaulted loan, the proceeds may be used to purchase additional loans. If the guarantee is lost on a defaulted loan, the indentures suffer a loss to the extent of any amounts not collected from the borrower.

6. Question: CSLFC raised over $2 billion in bond sales yet only $1.4 billion student loans are held by CSLFC. Where is the rest of the money?

Answer: In Mr. Fulp's written statement (at p. 9), he stated that "close to $2 billion" had been raised in financings by CSLFC and the letter of credit banks. This figure includes some refinancings. Of the amounts raised, the indentures maintain substantial funds in cash and other investments pending acquisition of student loans. In addition, some of the funds raised by the indentures have been used for administrative expenses, all of which to Bank of America's knowledge have been properly accounted for.

7. Question: What has happened to the value of the bonds in question?

Answer: Because interest and principal payments to bondholders are guaranteed by the letters of credit provided by the letter of credit banks, to Bank of America's knowledge the value of the CSLFC bonds have not been materially affected.

8. Question: Did Bank of America receive copies, on a timely basis, of the Peat Marwick audit opinions of UES' loan servicing?

Answer: The auditors provided annual audit opinions on CSLFC's financial statements, and as part of their audit reviewed the UES servicing operations. Bank of America, as trustee, received copies of the audit opinions from CSLFC on a timely basis as provided in the indentures.

9. Question: Did Bank of America ever conduct internal audits of the portfolio, of CSLFC, or of UES?

Answer: Bank of America as trustee was not obligated to and did not conduct internal audits of the portfolio, CSLFC, or UES prior to July 1988. There were reviews of UES conducted by the CSLFC auditors, the guarantee agencies, and at least one of the CSLFC letter of credit banks.

10. Question: Did CSLFC personnel ever inform Bank of America personnel of the potential problems at UES?

Answer: Prior to July 1988, CSLFC personnel never informed Bank of America personnel of potential problems at UES.

11. Question: Please explain the Bank of America release of UES as servicer and the hold harmless clause in that agreement?

Answer: In the Fall of 1988, Bank of America as trustee, the letter of credit banks, and all the other concerned parties (including the Department of Education) agreed that it was essential to promptly remove UES as the loan servicer and replace it with a new servicer who would adequately service the CSLFC loans. Before this could be done, an agreement had to be reached with UES. That agreement was reached on October 28, 1988. We have provided the Subcommittee Staff with a copy of the agreement.

Pursuant to this agreement, Bank of America as trustee for the CSLFC indentures purchased the UES assets necessary to continue servicing the student loans, including the UES database. Bank of America as trustee paid UES $1.2 million for these assets, which represented their book value. Also pursuant to the agreement, UES agreed to pay Bank of America as trustee $2 million in damages for the harm caused by its servicing failures. While this amount does not come close to approximating the harm caused by UES's conduct, UES had only very limited assets beyond this amount. After this agreement was signed, UES declared bankruptcy. Finally, pursuant to the agreement, UES received a conditional release, which can be voided if, at the time of the settlement agreement, any UES executives or officers made or knew about false statements to any party.

12. Question: Regarding the FIX and COMFIX computer programs, have you or the bank ever run into anything similar, i.e., computer programs designed to enter false information on loan servicing?

Answer: No.

13. Question: Trent Nebeker, the vice president of CSLFC, used to work for Bank of America's student loan department. Do you know if Mr. Nebeker used his connections with Bank of America at CSLFC to get Bank of America to act as trustee for CSLFC?

Answer: Bank of America was approached to act as trustee by bond counsel working on the CSLFC transaction, who had previously worked with Bank of America's trust department.

Trent Nebeker was not involved in any way. At the time Mr. Nebeker was still working in the Bank's student loan lending department (a group distinct from the trust group). After Bank of America became trustee, CSLFC had some contacts with Mr. Nebeker as the Bank's student loan department sold some loans to CSLFC. Later, in mid-1983 CSLFC hired Mr. Nebeker.

14. Question: What action has Bank of America taken with regard to its corporate trust account contracts in light of the findings at UES?

Answer: The Bank has reviewed its outstanding accounts and agreements to ensure that they clearly reflect the Bank's obligations.

15. Question: How many loans are affected by FIX and COMFIX? Are there any indications that other computer programs designed to falsify or remove data were ever used at UES?

Answer: Approximately 40,000 UES loans contain entries generated by the FIX and COMFIX programs. We note that for many of these loans the computer-generated entry had no effect on the servicing or collection of the loans.

Agent Hiller, of the Department of Education's Inspector General's Office, has alerted the Bank to loan files that appear to contain anomalies. The Bank is currently investigating these files. In keeping with its practice of fully informing the Department of Education of the results of its technical testing, Bank of America plans to report to the Department the results of its investigation.

STATEMENT

OF

GARRY D. HAYS

PRESIDENT

HIGHER EDUCATION ASSISTANCE FOUNDATION

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF

THE SENATE COMMITTEE ON GOVERNMENT AFFAIRS

SEPTEMBER 25, 1990

HEAF

A member of the HEAF group

Statement

of

Garry D. Hays

Before the

Senate Permanent Subcommittee on Investigations

September 25, 1990

Mr. Chairman and Members of the Subcommittee:

I am Garry D. Hays, President of the Higher Education Assistance Foundation (HEAF), a private nonprofit guarantor serving the Guaranteed Student Loan Program. I am accompanied by Ms. Wendie J. Doyle, Assistant Vice President and Compliance Officer of HEAF. We are here in response to your invitation to discuss HEAF's role in uncovering deficiencies in the servicing of student loans by United Education Software that were made by First Independent Trust Company and subsequently sold to the California Student Loan Finance Corporation. Before beginning these discussions, let me respond to your request that we also describe HEAF and its responsibilities as a guaranty agency in the Guaranteed Student Loan Program.

HEAF and Its Responsibilities

HEAF is chartered in the state of Minnesota and has agreements with the Secretary of Education to insure student loans for commercial lenders. While serving as the "designated" guarantor in Minnesota, Kansas, Nebraska, Wyoming, West Virginia, and the District of Columbia, HEAF--as a consequence of its willingness to serve students and lenders regardless of the states in which they are located--is a national guarantor as contrasted with similar agencies that restrict their activities to particular states. Since June, 1977, HEAF has guaranteed over $15 billion in student loans and has an outstanding portfolio totaling some $9.6 billion.

As a guaranty agency, HEAF has three responsibilities: (a) insuring loans made by commercial lenders, (b) encouraging lenders to participate in the Guaranteed Student Loan Program, and (c) ensuring that schools and lenders that participate in the Guaranteed Student Loan Program comply with the law and regulations governing the making and collecting of student loans.

Insuring Student Loans

HEAF and similar agencies insure lenders that the loans they make under the Guaranteed Student Loan Program to eligible students will not result in losses from default, death, bankruptcy, and disability of borrowers. In consideration for this insurance, federal law allows HEAF to charge lenders a maximum of 3% of the principal of the loan as an insurance premium which is intended to partially pay for the operation of the agency and to establish an insurance fund against which HEAF would apply insurance claims. Because this limited fee would not possibly cover the cost of defaults in the program unless they were less than 3%, the federal government stands behind guaranty agencies by reinsuring the loans.

Federal reinsurance payments on defaults which do not exceed five percent of the loans in repayment status at the beginning of a fiscal year are paid at 100 percent. Beginning at any time during the fiscal year when defaults exceed five percent and until such time as they exceed nine percent, reinsurance is paid at the rate of 90 percent. Beginning at the time defaults exceed nine percent reinsurance payments for the balance of the fiscal year are at 80 percent.

This arrangement is intended to be an incentive for guaranty agencies to minimize their default rates by penalizing them when their default rates rise. In reality, however, the arrangement disadvantages insurers that serve large populations of trade school students in their states' "areas of service." This disadvantage is evident in HEAF's current financial situation which is well known. As the proportion of defaults among its insured students rose as a consequence of the high proportion of high risk students it insured, HEAF's average reinsurance rate each year has fallen to about 89%. In other words, in recent years, HEAF has received 89 cents in reinsurance for each dollar of insurance claims it has paid for defaulted loans. Hence, since its inception, HEAF has incurred a cost of $212 million in defaults for which it was not reimbursed by the federal government. This savings for the federal government is the direct result of a fundamental contradiction in the Act that compels guaranty agencies to help high risk young people attend postsecondary education but does not either (a) provide the agencies effective mechanisms for controlling the risk in their portfolios or (b) assure that agencies can finance any extraordinary risk they may be compelled to assume. Nevertheless, guaranty agencies are expected to promote lender participation in the program and assure students access to loans so they can attend postsecondary education institutions.

Once guaranty agencies purchase defaulted loans from lenders, they are obligated under the law diligently to collect the defaulted loans and are financially rewarded for their success. Using an array of resources such as collection agencies, the Internal Revenue Service, their own collectors, and the courts, agencies convert about 26% of all defaulted loans they purchase into paying accounts.[1] HEAF's experience over twelve years shows that almost thirty-five percent of defaulted loans can be recovered over time.

A pilot debt collection study conducted for the Department of Education by American Management Systems indicates that over a thirty month period HEAF was the only large guarantor which consistently achieved better results than the Department of Education in a scientifically structured "head-to-head" competition in collecting defaulted loans. HEAF consistently realized a higher recovery rate at a lower cost per dollar collected. During this fiscal year, HEAF will refer over 500,000 accounts to 12 collection agencies, will refer over 700,000 accounts to the IRS for the purpose of obtaining current addresses or withholding tax refunds, and its 203 loan collectors will place over 2 million telephone calls and send 1.2 million letters to defaulted and delinquent borrowers to convert them into paying accounts. As a result of this effort HEAF will collect $105 million this year from borrowers who previously defaulted on their loans and will, on any given day, be litigating about 12,000 cases using law firms throughout the United States as part of its collection efforts.

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[1] U. S. Department of Education, 'FY 1988 Guaranteed Student Loan Programs Data Book, Washington, D.C.: U. S. Department of Education, undated, p. 56.

Promoting Lender Participation and Student Access to Loans

The Act thrusts on guarantors responsibility for promoting lender participation in the Guaranteed Student Loan Program and requires such agencies to serve all eligible students and institutions within their area of service. HEAF has been willing to assume these responsibilities nationwide and acted to assure all eligible students access to student loans regardless of where they lived or attended school.

HEAF has been responsible for establishing lending programs for special groups of underserved but eligible students and for helping lenders meet the demonstrated needs for loans of all eligible students. For example, HEAF, Citibank and the Student Loan Marketing Association established a special loan program for students at schools that are members of the United Negro College Fund. Moreover, the original guaranty agency in the District of Columbia was financially unable to honor its insurance contracts with lenders, HEAF was asked to assume guaranty agency responsibility for the District and restore lenders' confidence in the program. HEAF was remarkably successful in fulfilling this responsibility and has reduced the District's reliance on the lender of last resort. During the early to mid 1980's, the District's lender of last resort made 8 out of every 10 loans in the District, a ratio that has now been reversed.

In an effort to promote lenders' participation in the program and use of HEAF's services, HEAF established new standards for services to students and schools. In the mid 1980's, students typically had to wait nine to twelve weeks after completion of their loan applications before they were notified of the availability of their loans. HEAF developed state of the art processes that reduced this "turnaround" time to today's standard of hours. In addition, HEAF pioneered the use of computer technology in exchanging information among the lenders, students, and schools thereby reducing the cost to colleges and universities in administering their student aid programs. According to data provided by the Department of Education, HEAF is one of the five most efficient agencies in the country. Lenders have directly benefited from these improvements in efficiency which reduce costs and maximize profits. Hence, our services encourage lenders' participation in the program.

Compliance

Guaranty agencies are required by the Act to take appropriate steps to ensure that schools and lenders are administering the Guaranteed Student Loan Program in accordance with the statute and applicable regulations. In addition to extensive computerized auditing and checking of loan applications, agencies undertake two major activities to assure compliance with the law: (a) close examination of the diligence with which lenders make and collect loans, particularly defaulted loans, and (b) reviews of the manner in which eligible schools and lenders are administering the program.

Claims Examination. Each and every insurance claim submitted by lenders for default, death, bankruptcy and disability is closely examined by one of HEAF's claims examiners. When submitting insurance claims, lenders must fully document their compliance with extensive and detailed requirements to diligently attempt to collect all delinquent loans. Claims that do not meet the criteria for diligent efforts to make and collect the loans in accordance with the law are rejected or interest penalties are assessed. During the current fiscal year, HEAF has examined more than $1 billion of insurance claims, rejected or refused to pay about $125 million of claims and imposed over $9 million of interest penalties on lenders whose diligence in making or collecting loans did not meet the letter of the law.

Program Reviews. The Act and Code of Federal Regulations (34 CFR 682.410) require guaranty agencies periodically to review lenders and schools that participate in the Guaranteed Student Loan Program. In addition, agencies are obligated to conduct program reviews of lenders and schools which they have reason to believe are unintentionally or intentionally violating the law in the administration of the Guaranteed Student Loan Program.

Because HEAF serves as designated guarantor in six states, it is required under the regulations to perform 60 school and 60 lender reviews over a two year period, as well as review certain selected schools with a default rate in excess of 40%. HEAF has consistently exceeded these requirements in the number of reviews performed.

During the past 24 months, HEAF's Compliance department has conducted 207 program reviews, 120 of which were of schools and 87 of which were of lenders. As a result of these reviews, HEAF undertook limitation, suspension or termination action against 49 schools and lenders and referred 10 schools to the Department of Education recommending their disqualification from the Guaranteed Student Loan

Program. A total of $3.9 million has been collected from schools and lenders for payment of HEAF-identified liabilities and refunded to students and the federal government. All reports of program reviews are on file with the Department of Education.

Having described HEAF and the responsibilities it fulfills as a guaranty agency in the Guaranteed Student Loan Program, the following sections address the issue of fraud and abuse in the program. As requested by the Chairman, we will also comment on HEAF's widely publicized financial condition.

Fraud and Abuse in the Guaranteed Student Loan Program

Instances of fraud and abuses of the Guaranteed Student Loan Program have been documented by the Department of Education's Inspector General and the hearings your Subcommittee is conducting[2]. However, it is an unfortunate misperception that fraud and abuse are rampant throughout the Guaranteed Student Loan Program. The popular perception is that students routinely abuse the program by refusing to repay their loans, that schools routinely bilk unwitting poor students into taking loans to attend ineffective education programs, that lenders are abusing the program by not collecting loans, and that the guaranty agencies are not enforcing the law and that fraud goes undetected in the program.

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[2] For example: Office of the Inspector General, "Semiannual Report to Congress", No.'s 19 and 20, Washington, D.C., October, 1989 and April, 1990, respectively.

Although it is true that the default rates among students are higher than default rates on other consumer loans; that a few citizens, schools and some lenders have abused the program and even committed fraud; and that improvements in preventing and identifying problems can be made; it is equally true, but less newsworthy, that the program has served this nation well by generating over $13 billion in financial aid for students to attend postsecondary education in this country each year. As we discuss the fraud and abuse in this program, we urge you and the media to be mindful that Congress has chosen the Guaranteed Student Loan Program as the primary vehicle for helping high risk and demonstrably needy students--from socio-economic backgrounds which are under represented in postsecondary education--to pay for their postsecondary education, thereby improving their economic circumstances and becoming productive members of our society. Any program that serves this purpose well by providing 4.5 million students financial aid each year to attend tens of thousands of schools by borrowing monies from thousands of lenders that are insured by 46 guaranty agencies is bound to have some fraud and abuse. While cases of fraud and abuse by borrowers, schools and lenders can be identified, we urge you to resist the temptation to over generalize from a few documented, egregious criminal acts and abuses of the program and erroneously portray the entire program as permeated by fraud and abuse.

Fraud and Abuse by Borrowers

Borrowers can defraud the program by obtaining loans for which they are not eligible, by obtaining more loans than the law allows, or by refusing to repay their loans when they have the resources to do so. Although instances of fraud and abuse by borrowers have been uncovered and will continue to be uncovered, we find no compelling evidence that fraud and abuse by borrowers is out of control.

The Inspector General's reports to the Congress that describe federal and state prosecution of fraud by borrowers illustrates that some borrowers have obtained loans through fraud. The reports also illustrate that such instances are identified and that prevention of all fraud is an impossible task if the program is to provide adequate services to students and their families. For example, HEAF's computer programs perform over 500 checks on data and information presented by each loan applicant before the loan is insured. HEAF's entire data base is searched for information about previous loans, and social security numbers are subjected to edits recommended by the Social Security Administration to assure their legitimacy. Yet, despite these efforts, some citizens obtain loans for which they are not eligible or borrow more than the law allows. It is important to note that in each case the borrower has figured out how to fool the financial aid office at an institution, the lender, and the insurer of the loan.

Perhaps the most popular misperception about the student loan program is that students routinely abuse it by simply refusing to repay their loans despite having the resources to do so. Although it is true that default rates may be high compared to other kinds of consumer credit programs typically involving borrowers with collateral and other credit requirements, it has not been demonstrated that student loan defaulters are borrowers who simply are unwilling to repay their loans.

According to the Department of Education, about 20% of all borrowers default on their student loans.[3] However, this figure varies according to the type of institution the borrowers attended. About 37% of students who attend proprietary trade schools default, about 27% of students who attend public two year colleges default, and a little over 10% of students who attend four year colleges and universities default. As demonstrated by numerous studies, defaults have increased in this program because of its nature and purposes and the cost of defaults have increased simply because of the enormity of the program.[4] About $50 billion of loans have matured since its inception.

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[3] United States Department of Education, "FY 1988 Guaranteed Student Loan Programs Data Book," Washington, D.C.: Office of Postsecondary Education, United States Department of Education, undated, p. 39.

[4] California Student Aid Commission, "Student Borrowing in California, A Report on Student Participation in California's Educational Loan Programs, Sacramento: California Student Aid Commission, March, 1988; The College Board, "Trends in Student Aid: 1980 to 1989," Washington, D.C.: The College Entrance Examination Board, August, 1989; General Accounting Office, "Guaranteed Student Loans, Comparisons of Single State and Multistate Guaranty Agencies," Washington, D.C.: General Accounting Office, July, 1989; General Accounting Office, "Defaulted Student Loans, Preliminary Analysis of Student Loan Borrowers and Defaulters," Washington, D.C.: General Accounting Office, June 1988; General Accounting Office, Supplemental Loans, Who Borrows and Who Benefits, Washington, D.C.: General Accounting Office, October 1989; Hauptman, A., "The Tuition Dilemma, Assessing New Ways to Pay for College," Washington, D.C.: the Brookings Institution, 1990; Higher Education Services Corporation, "Student Loan Payers and Defaulters," Albany, N.Y.: Higher Education Services Corporation, 1985; Mortensen, Thomas G., "The Impact of Increased Loan Utilization among Low Family Income Students," Iowa City, Iowa: The American College Testing Program, 1990; National Center for Education Statistics, "Undergraduate Financing of Postsecondary Education, a Report of the 1987 National Postsecondary Student Aid Study," Washington, D.C.: Office of Educational Research and Improvement, U.S. Department of Education, June, 1988; and Wilms, W. W., Moore, R. W., and Bolus, R. E., "Whose Fault is Default? A Study of the Impact of Student Characteristics and Institutional Practices on Guaranteed Student Loan Default Rates in California," *Educational Evaluation and Policy Analysis*, *9*(1), 41-54.

Since the Program's inception in 1965, Congress has made changes that have modified the program from one designed to help middle class parents finance their children's college education to a program that maximizes the likelihood of high default rates and costs by restricting lending to needy young people, many of whom have not experienced any previous academic success, regardless of their prospects for future earnings. It is clear that the vast majority of borrowers who default on their loans do so only because they do not have the resources to repay their loans. This is virtually assured by the changes Congress and the Department of Education have made in the Program to enhance the ability of lenders and guaranty agencies to collect defaulted loans. By making the services of the Internal Revenue Service available to track defaulted students, by requiring lenders to report defaulters to credit bureaus, by encouraging diligent collection efforts, by encouraging agencies to garnish wages and by having the Internal Revenue Service withhold tax refunds of defaulted borrowers, Congress can assure their constituents that very few borrowers who have the resources to repay their loans avoid their responsibility. There is no study of which I am aware that substantiates the popular perception that students routinely abuse the student loan program by refusing to repay their loans. In fact, all the studies to date agree that most defaulters simply do not have the financial means to repay their student loans.

Fraud and Abuse by School Officials

To discuss this topic candidly and realistically it is necessary to focus this part of my discussion on proprietary, for profit, trade schools which are also the focus of much of your investigation and are the schools most often cited for abuses and fraud. This Subcommittee has already heard from witnesses who are either under investigation or incarcerated, or whose schools have been terminated from participating in this program for their failure to administer the student loan program properly. Fraud and abuse of the program by school officials can take many forms ranging from recruiting and admitting students who have little chance of benefiting from the education program to fraudulently certifying loan applications to failing to pay refunds when students withdraw.

Given the purpose of the Guaranteed Student Loan Program, it is somewhat surprising that more fraud and abuse have not been documented. In fact, the very purpose of the program, as reflected in the eligibility criteria for students to obtain loans, provides substantial opportunity for unscrupulous school officials to abuse the program by taking advantage of needy students who want to improve their economic circumstances through education. However, the dilemma you face is balancing the need to minimize opportunity for fraud and abuse by school officials and preserving the ability of the program to continue to help those most in need of education and training and the least able to afford it. Every effort you make to prevent fraud and abuse by school officials has the potential of reducing educational opportunity for students with backgrounds under represented in postsecondary education.

This Subcommittee, the Inspector General of the U.S. Department of Education and HEAF have documented the kinds of abuses and fraud committed by school officials.

These cases involve circumstances represented by one of your previous witnesses, Mr. Tommy Wayne Downs, whose criminal actions have resulted in his conviction and incarceration, largely as the result of HEAF's investigation. There is no evidence to date that Mr. Downs' behavior is widely replicated by other school officials despite diligent efforts of guaranty agencies, Department of Education officials and law enforcement officials to identify such cases. It is inevitable that some similar cases may be uncovered in the future as the consequence of the size of this program and the opportunities that are inherent in any large scale program, but we believe they will be rare.

Although HEAF is responsible for and undertakes to deal with loan program administration, there are other problems with which we cannot deal. For example, HEAF often receives complaints from students, particularly those who have withdrawn from their schools, about the poor quality of the education or training offered by their former school, about the manner in which they were recruited and admitted to the school and about the misleading statements made by school representatives when they described what turned out to be a loan as a grant. Despite our concerns that such complaints might prove true, HEAF finds itself with limited capacity--under current regulations and law--to end the eligibility of schools or programs accused of such deficiencies to participate in the Guaranteed Student Loan Program.

The Act gives to the Department of Education sole authority to grant eligibility to educational institutions in Section 428(b)(1)(T) and 34 CFR §§600, 668 and 682(e)(4). According to the Department of Education's reading of the law, Sec. 428(b)(1)(T) and Sec. 428(c)(2)(F) prohibits agencies from taking any actions against institutions unless it can be documented that they have broken the law or violated regulations that govern the program. Moreover, guaranty agencies are strictly prohibited from terminating the eligibility of institutions solely on the basis of high default rates by 34 CFR §668, although under 34 CFR 682.410 agencies are required to frequently review schools with high default rates. Finally, guaranty agencies should not, nor are they authorized by the Act to judge the quality of education offered at schools even when they receive complaints from students and former students that the education program and resources at a particular school are abysmal. The capacity of guaranty agencies to end the eligibility of schools in the Guaranteed Student Loan Program is limited to situations in which school officials violate the law or regulations governing the program.

However, guaranty agencies do have sufficient powers to act against schools that violate the law and regulations in the administration of the student loan program. Our most frequent action is directed at institutions that either intentionally or unintentionally do not make refunds of tuition and fees to students in a timely manner, or at all. Failure to make refunds should be viewed by Congress as an egregious act against the program, students and lenders. Unfortunately, the incentives for school officials to delay or forget to make refunds outweigh available penalties to ensure compliance with refund requirement.

The problem involving First Independent Trust Company and related organizations

The particular situation Ms. Doyle and I have been invited to address represents the largest operational failure in the history of the student loan program. It involved a number of entities engaged in practices which--when combined--led to the loss of millions of dollars and resulted in hardship for thousands of borrowers.

In order to understand fully that which occurred, it is first necessary to identify the organizations involved and their respective roles.

First Independent Trust Company (FITCO) which, until the mid-80's, was a small trust company headquartered in Sacramento, California, engaged in a modest amount of student loan lending, although it technically did not meet the law's definition of an "eligible" lender, §435(d). By virtue of a special exemption in the 1986 amendments to the Higher Education Act (the Act), FITCO was grandfathered into the Guaranteed Student Loan Program as an eligible lender. FITCO had begun originating loans under the HEAF guarantee in late 1985, although it continued to rely, also, on the California Student Aid Commission (CSAC) to insure some of its loans.

The manner in which FITCO conducted business can best be described by examining three characteristics of its lending practices. First, FITCO experienced phenomenal growth in the latter half of the 1980's. In FY 1986, FITCO originated $1.4 million in HEAF-guaranteed loans. In FY 1987, this number jumped to approximately $260 million; and in FY 1988, FITCO's volume with HEAF was $299 million.

A second characteristic of FITCO's business practices was the quick sale of its loans. FITCO sold loans to secondary markets within days of making the first disbursement. While FITCO sold to several secondary markets near the end of its existence, its major outlet for loans was the California Student Loan Finance Corporation (CSLFC).

A third characteristic of FITCO's business was its portfolio mix. Of the approximately 350,000 loans that FITCO made with the HEAF guarantee totaling over $560 million, $547 million (or 97.7%) went to students attending proprietary schools. This type of paper typically has a cancellation rate in excess of 30% and a default rate at least four times that of four-year paper.

By 1988, FITCO was one of seven major lenders using the HEAF guarantee to make proprietary loans in aggregate at the rate of $1.5 billion per year. HEAF attempted to control this volume by exercising a provision in its lender agreement with FITCO which permitted cancellation of the agreement with 60 days notice. However, HEAF was told by the Department of Education that it could not simply discontinue a business relationship with a lender without first finding sufficient cause for an administrative action, and lending in huge dollar amounts to students attending high default institutions is not sufficient cause.

California Student Loan Finance Corporation (CSLFC) is a California nonprofit corporation which functions as a secondary market for student loans. Although CSLFC itself is not an eligible lender under the Act, it uses a section of the statute which allows virtually any entity to hold loans under a trust agreement with an eligible lender. CSLFC's trustee for the purpose of holding student loans is Bank of America. CSLFC financed its loan purchases through the sale of tax exempt bonds and the sale of commercial paper. To minimize the risk for purchasers of its bonds, CSLFC arranged for a number of foreign banks to promise to make good on principal and interest owed the bond holder should CSLFC be unable to meet its obligations to the bond holders. This is a customary credit enhancement practice in the financial markets and is known as "obtaining letters of credit". All CSLFC loans were bought and sold under various Bank of America trust indentures, most of which were backed by letters of credit from Japanese banks and Citibank.

United Education Software (UES). Under the trust agreements with Bank of America, as CSLFC purchased loans it assumed responsibility for performing the required diligent efforts to maintain the accounts of the borrowers and to undertake extensive collection efforts when borrowers became delinquent in their payments. This is known as "servicing loans". Instead of servicing the loans it held on behalf of Bank of America, CSLFC contracted with United Education and Software (UES), a servicing company located in Costa Mesa, California, to service most of the loans. In addition to servicing loans for some lenders, UES at that time also owned approximately 40 proprietary schools around the country. In the mid-1980's, UES experienced explosive growth in both its school and servicing businesses. UES' servicing growth paralleled the growth of FITCO and CSLFC. UES went from servicing under $100 million of student loans to servicing over $1 billion in student loans in approximately two years.

Yet another aspect of this enterprise developed in fiscal year 1987 when FITCO entered into an arrangement with UES for origination services. This arrangement meant that as students and schools completed loan applications, they were sent to UES instead of FITCO where UES would examine the applications for eligibility information and actually write the loan checks on behalf of FITCO. FITCO never saw or touched the loan applications. Similar "origination" services are provided to lenders by other loan servicing corporations and guaranty agencies, but this was the only situation in which a company was originating loans for students at schools it owned. Over the next two years, UES originated nearly $26 million on behalf of FITCO. All of these loans were immediately sold to CSLFC. While $26 million is not that significant compared with the overall FITCO loan volume, two things must be noted. First, more SLS than GSL loans were being made, indicating that schools were encouraging students to take out higher-balance, higher-cost loans without first examining eligibility for Stafford loans, a practice Congress has now prohibited. Second, 97 percent of the loans that UES originated on behalf of FITCO went directly to students enrolled in UES owned schools.

UES, CSLFC and FITCO continued to grow until mid-1988 when it became apparent to HEAF that major problems existed, not just with a single aspect of the arrangement but with almost every facet of the enterprise that had been built. What follows is a description of the problems that were discovered at UES and FITCO.

On March 10, 1987, new regulations became effective which required more specific acts of "due diligence" within certain timeframes than had previous standards in order for a default claim to be paid. The due diligence that was required included sending a number of collection letters, making a number of phone calls, "skip tracing" borrowers whose addresses and phone numbers had changed, requesting preclaims assistance from the guarantor to help collect the loan before it went into default and sending a "final demand" letter. As the UES serviced loans began to default at extraordinary rates and were submitted to HEAF for insurance payments, the loans failed in almost every instance to meet the March, 1987 "due diligence requirements" in collections. In fact, UES failed to perform one of the most important successful and required default avoidance acts by failing to request from HEAF help in collecting the loan before the borrower technically defaulted. This is known as preclaims assistance, a process through which HEAF resolves more than 60 percent of delinquencies reported by lenders. This failure to request assistance caused HEAF to reject all UES insurance claims for defaulted loans beginning in October, 1987. Since UES failed to submit the required request for preclaims assistance, the claims failed to pass the initial edits in HEAF's system and were rejected as ineligible without further review.

In March, 1988, the Department of Education issued "Dear Colleague Letter 88-G-138" known as the "cure bulletin". A cure procedure to resolve inadvertent administrative and operational errors in the good faith servicing of a loan is a desirable feature for the program. Quite appropriately this policy allowed lenders to "cure" inadvertent violations of due diligence collection regulations after insurance claims had been denied. Once the collectibilty of the loan was demonstrated by the "cure,"--either locating the borrower or locating the borrower and receiving either a signed repayment obligation or one payment--the insurance claim could be resubmitted to HEAF for reimbursement.

However, the effect of G-138 was to allow all the claims previously denied UES to be resubmitted for payment. In April, 1988, HEAF began receiving large numbers of claims from UES. In reviewing these claims in detail and in conversations between borrowers and our Preclaims and Collection departments, several concerns became apparent within a matter of weeks:

1. Numerous borrowers indicated that they had never heard of UES, had never received instructions for repayment of their loans, and had not received the letters and phone calls indicated on the UES collection histories.

2. Other borrowers complained that their requests for deferments or forbearance were ignored and that UES had even returned payments to them that they had made on their loans.

3. Although some of the insurance claims were payable by HEAF, most of the borrower histories indicated only minimal efforts were made to contact the borrower.

4. Claim files contained copies of collection letters supposedly sent to borrowers although the records of collection efforts contained no indication that the collection letters were sent.

5. Collection records indicated telephone calls being made 24 hours a day and that the same collectors always achieved the same results,

e.g. one collector always reached a bad number, another collector could never contact a borrower directly so he always left a message for the delinquent borrower to call back.

6. UES submitted claims with invalid borrowers' addresses certified as accurate causing severe problems in post-default collection of the loans.

During the two to three weeks when HEAF was examining these matters in-house, UES continued to file thousands of new claims on behalf of CSLFC and Bank of America. In order to prevent payment of any further insurance claims to CSLFC until HEAF could satisfy itself that the loans were being properly serviced, HEAF notified the Department of Education and the Inspector General's Office of the suspected problems and arranged an immediate on-site review of UES servicing in Costa Mesa. In June, 1988, two members of HEAF's Compliance staff and a special agent from the Inspector General's Office conducted the on-site review of UES.

This four-day review uncovered serious irregularities by UES. For example, hundreds of boxes were found in the UES warehouse containing thousands of pieces of unopened returned mail. Federal due diligence requirements require "skip tracing" to be performed when there is returned mail for a borrower. UES was not attempting to "skip trace" the borrowers and represented in its insurance claim papers that the borrowers' addresses were correct and no skip tracing was required. In other boxes, the review team found thousands of unprocessed requests by former students for available deferments and forbearance to which they were entitled. Not only are borrowers statutorily entitled to deferments, the use of such deferments and forbearance are two of the most effective tools for preventing defaults and keeping program costs down. By not responding to these requests, UES maximized default rates and costs to taxpayers and insurers of the loans and caused the borrowers extraordinary hardship.

Based on the preliminary review of UES, HEAF notified the Department that it was suspending claim payments to UES and the Department notified guarantee agencies on August 2, 1988 that reinsurance on any loans serviced by UES was suspended.

Also in August, 1988, a joint in-depth review of UES was conducted by representatives of HEAF, California Student Aid Commission and the Department of Education. This team assessed the scope of the known servicing irregularities and uncovered others. Some of the major findings of this review are as follows:

1. UES routinely billed borrowers for monthly payments up to double the amounts authorized by law, failed to apply borrower payments properly, and provided borrowers confusing and conflicting information about their accounts. These results stemmed from UES' inability to properly combine and service the several disbursements of a student loan into a single loan amount.

2. UES failed to perform proper due diligence (the review sample noted a 92% error rate) in servicing loans.

3. UES failed to process over 100,000 student status changes, deferments and forbearance requests from schools, guarantors and borrowers thereby maximizing default rates and costs.

4. UES' collection histories were inaccurate and contained entries of telephone calls that were never made and letters that were never sent--such collection histories were knowingly used as the basis for insurance claims submitted to guarantors who, in good faith, submitted them to the federal government for reinsurance.

5. UES overbilled the government for interest and special allowance benefits due CSLFC.

6. UES was unable or unwilling to keep accurate and up-to-date records of their work. Knowing submission of claims with invalid borrower addresses certified as accurate caused severe problems in post-default collection of the loans.

7. UES did not notify borrowers that they were obligated to begin repaying their loans as required by federal regulations.

8. UES delayed posting payments to borrower accounts, often resulting in borrowers unknowingly and unlawfully being charged late fees.

9. UES did not have sufficient staffing to perform proper servicing and

virtually refused to respond to borrowers' inquiries and complaints.

During the following months and through the subsequent investigations that took place, many more problems were identified in UES' servicing of loans. For example, several millions of dollars of refunds were found in "suspense accounts" waiting to be credited to students' loan accounts. For various reasons relating to both UES and FITCO, these funds were not only not applied to borrowers' accounts, but were left idle with no attempt to research the proper recipient of such funds. Because the refunds were not properly credited to students' accounts, the accounts showed loan balances in excess of what they should have been.

Most egregiously, in 1989, it was disclosed by Bank of America that the computer tape library at UES contained computer programs whose sole purpose was to retroactively insert due diligence entries onto collection account histories in order to make it appear that required due diligence had been performed when it had not. By the time this discovery was made millions of dollars of insurance claims had already been paid by HEAF and the California Student Aid Commission based on collection histories containing falsified entries.

Although FITCO sold its loans almost immediately after origination and, therefore, performed virtually no servicing of the loans, severe irregularities occurred in the disbursement process. In making student loans, a lender typically withholds the origination and guarantee fees from the face amount of the loan. The 5% origination fee is to be paid to the Department of Education every quarter (or offset against interest and special allowance due the lenders) and the guarantee fee is typically paid to the guarantor within 30 days after disbursement. HEAF bills its lenders for fees based on scheduled disbursement dates, using a format which allows lenders to cancel disbursements not actually made or returned by a school. If cancellations occur after the fee is initially paid, HEAF returns the guarantee fee to the lender to credit the borrower's account.

FITCO's procedures were to fund the loan by sending a check to the school and student for 92% of the face value and then to sell that loan within days to CSLFC or another secondary market for par, plus a 1% transfer fee. FITCO failed, however, in significant instances to pay either the origination fee or the guarantee fee despite having already been reimbursed for such fees in the loan sale. At this point, within days of disbursement, FITCO had netted an illusory 9% return on the loan.

FITCO's procedures were further flawed with respect to cancellations and refunds. These activities were often not properly accounted for on FITCO's books, with the result that the funds were never forwarded to the secondary markets. FITCO again retained funds intended for other purposes. Although HEAF cannot comment on the purpose or intent of FITCO in taking the above actions, all such practices have been well-documented.

In April, 1989, HEAF conducted a program review of FITCO amid serious concerns over FITCO's unpaid guarantee fees and reports from schools that FITCO was failing to disburse checks on loans that FITCO had committed to fund. The findings of the review were so serious in nature that HEAF immediately suspended

FITCO's participation in HEAF's guarantee programs and began a termination action.

The major findings of the FITCO review are as follows:

1. Failure to safeguard and forward refunds to secondary markets in a timely manner. During the on-site review, HEAF personnel observed refund checks laying unsecured on a bookshelf next to an outside door. It was estimated that there was over $4 million worth of such checks which FITCO had taken no steps to process or forward to the current holders of the accounts. Although conflicting reasons for such lack of control were given by FITCO officials, it soon became apparent that FITCO was using their own borrowers' refunds to offset amounts it felt it was owed by CSLFC.

   Aside from the FITCO/CSLFC dispute, there were other major problems with refunds. As of March 31, 1989, FITCO's own accounting records indicated over $1.2 million of refunds which had not been forwarded to current loan holders. Some of the refunds had been received by FITCO more than three years prior to that date. When refunds were forwarded, there were extreme delays causing the current holder to overbill the government for interest and special allowance.

   It was also determined that FITCO could not account for all the refunds it had received and that, in fact, some of the refunds were used by FITCO for its own purposes. Given FITCO's accounting practices and its failure to always record receipt of refunds, the true extent of FITCO's misappropriation will never be known.

2. Failure to cancel loans promptly. By not repurchasing loans from secondary markets that were not actually made, the books of the secondary markets contained loans that did not exist. In turn, this has led to payment of insurance claims for nonexistent loans. An Inspector General's audit of FITCO issued in 1988 concentrated on this cancellation problem. However, the audit findings were never resolved and the practice continued.

3. Non-payment of origination fees. Even though FITCO withheld the origination fees from borrowers' proceeds, FITCO failed to pay these fees to the Department of Education after January 1, 1988. According to FITCO's internal records, over $4.6 million was owed for 1988. Although FITCO filed the required form for two of the quarters indicating substantial amounts owed, the Department's response was to send a single request for payment within 30 days. No further follow-up action was taken to collect the funds or alert affected parties.

4. Non-payment of guarantee fees. As was the case with origination fees, FITCO withheld the guarantee fees from the borrowers' loan proceeds and was reimbursed for such fees when the loans were sold. Despite extensive efforts by HEAF to collect past due fees to permit

FITCO to reconcile accounts with its secondary markets--and the granting of extensions of several deadlines--FITCO failed to pay a significant portion of these past due fees. Finally, on May 11, 1989, HEAF cancelled the guarantees on approximately $60 million of loans for non-payment of fees.

5. Commingling of funds. The examination of FITCO's banking and accounting records indicated that FITCO was commingling funds it held in various capacities in a single account. Tuition refunds, proceeds from the sales of loans, and investment earnings were all deposited into a single account. The funds in this account were used to fund new loans, pay guarantee fees, and cash out trust participants. This manner of doing business has caused significant losses to the guarantee agencies and the Federal government, not to mention the harm to individual borrowers and FITCO investors.

As a result of the foregoing, CSLFC was faced with holding a massive student loan portfolio which had been declared uninsured by the several guarantee agencies and unreinsured by the Department of Education. Interest and special allowance payments were also suspended by the Department of Education, effectively terminating revenue flow to CSLFC.

These events also had obvious implications for CSLFC's Trustee, Bank of America, the various letter of credit banks, the Department of Education, and the three guarantors involved. As a result, discussions began in fall, 1988, in an effort to find an acceptable resolution to this problem and subsequently evolved into two separate sets of negotiations. Bank of America was dealing directly with the Department of Education and was also negotiating with HEAF. In the course of its negotiations with the Department of Education, Bank of America secured certain concessions which restored reinsurance for most of the loans in the CSLFC portfolio and also avoided the normal consequences for missing documentation and other shortcomings in the servicing of these loans. With some exceptions, the net result was that the due diligence violations of UES were to be treated in the same manner as inadvertent servicing errors made by other lenders, i.e., they could be "cured" by locating each borrower and securing a signed reaffirmation of the debt or a monthly payment.

In May, 1990, HEAF and Bank of America arrived at a tentative settlement. That settlement, however, required Bank of America to reimburse HEAF for a portion of the extraordinary costs associated with the portfolio and was explicitly predicated upon HEAF being able to secure approval from the Department of Education of a plan under which HEAF would be reimbursed for the remaining portion of the extraordinary costs. Such a plan was clearly appropriate and necessary for the following reasons:

(1) The ultimate default rate expected from this portfolio is estimated at 75 percent, a result which represents a significant loss (up to $85 million) to HEAF; and

(2) The ultimate collectibility of the loans has clearly been severely damaged as a result of the servicing errors of UES. As a consequence, HEAF will not be in a position to realize its normal post-default recovery from these loans.

At the present time--because our concurrence was predicated upon obtaining relief for these extraordinary costs--HEAF continues to refuse to honor claim requests for all but a limited number of Bank of America claims. The Department of Education has asked HEAF to delay formally rejecting the tens of thousands of claims we have received until September 30, 1990. Absent further instructions or a resolution of this matter by that date, HEAF will have no choice but to reject the claims.

The case we have cited is a disaster for taxpayers, the federal government, Bank of America, HEAF, California Student Aid Commission, and the Guaranteed Student Loan Program. The magnitude of the problems and costs and impact of the case on thousands of students and investors is regrettable. But, we respectfully remind the Subcommittee that out of all of the servicers and holders of loans in this country, there have been only three cases of serious deficiencies in the collection of loans, one of which resulted in criminal fraud convictions and the other two in substantial financial penalties for violations of the law and regulations governing the making and collection of guaranteed student loans. As evidenced by HEAF's denial of insurance claims and assessment of interest penalties each year, which were previously reported in this statement, reviews of lender practices are continuous and we firmly believe that any future cases of negligence and criminal behavior will be routinely uncovered as they have been

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in the past.

Accountability by Guaranty Agencies

Public comments about HEAF's recent financial difficulties of HEAF and some previous testimony before this Subcommittee have accused HEAF, and by implication some other guaranty agencies, of abusing this program by not diligently examining loan applications to protect the government from reinsuring fraudulent loans. Persons making such charges confuse efficiency with laxity and clearly do not understand the cost to guaranty agencies of insuring loans for ineligible students, fictitious or real.

Evidence of laxity in examining applications was cited as: (a) insuring a loan within hours of the application being submitted and (b) approving fraudulent applications. Such accusations confuse efficiency in providing services to lenders, students and schools with diligence in review applications for eligibility. In HEAF's case--as noted previously--it subjects each loan application to over 500 edit checks to assure itself that the applicant is eligible for a loan and use Social Security Administration's edits to check the validity of reported social security numbers. Frankly, such extensive editing and checking is required to protect HEAF since loans that are ineligible for interest benefits under the program are not reinsured by the federal government. Consequently, such extensive examination of applications by computers is necessary and routine.

Guaranty agencies are accountable to a variety of authorities. First of all, the agencies are accountable to their Boards of Directors, and in the cases of state agencies, the state legislative and executive branches of government. Moreover, law requires that agencies submit independently audited financial statements and reports of program audits periodically. In addition, agencies are subject to reviews by the Inspector General of the U.S. Department of Education, program officials at the Department of Education, and in the cases of state agencies, state auditors and examiners. HEAF has recently been examined by the Inspector General, the Department of Education, and the Office of Management and Budget. Although the results of the most recently completed reviews have not been formally shared with us, it is our understanding that HEAF has been judged to be not only in compliance with the law in every area but also a well-managed, efficient organization.

Evaluating Proposals to Reduce Fraud and Abuse

As this Subcommittee and the two Congressional "authorizing" committees examine the Guaranteed Student Loan Program, a litany of legislative proposals have emerged that are intended to minimize fraud and abuse. As we have pointed out earlier, Congress is faced with the historic problem of balancing the need for having an effective and efficiently run program that serves its intended beneficiaries well with the need to reduce opportunity for fraud and abuse. Every contemplated legislative and regulatory action to prevent fraud and abuse has a potential for inhibiting educational opportunity for needy students. Accordingly, we firmly believe that the emphasis should be on enforcement rather that prevention. In any case, all proposed legislative and regulatory proposals to minimize fraud and abuse must be carefully examined for unintended ill effects on students and the cost of operating this program for the federal government, schools, lenders and guaranty agencies.

HEAF's Current Financial Circumstances

You asked that we comment on HEAF's current financial circumstances and we do so, recognizing that as this document is being prepared the U.S. Department of Education and the Office of Management and Budget are making decisions that will directly affect HEAF and its employees. Nevertheless, we have attached the statement about this topic which Mr. Richard C. Hawk, Chairman of HEAF, made to the Senate Subcommittee on Education, Arts and Humanities on August 3, 1990.

There exists an erroneous perception, fostered by some of our competitors and statements by certain officials in the Department of Education, that HEAF attempted to capture the market of high risk trade school loans. There is the implication that the majority of HEAF insured loans were made by lenders to students attending trade schools. HEAF's published data show that although during 1988 when HEAF was desperately trying to reduce the proportion of trade school loans it was insuring (about 61% of all newly insured loans during the year), the proportion of trade school loans in HEAF's active portfolio never exceeded 41%. Today, HEAF's portfolio is comprised of 61% four year loans; 32% proprietary school loans; and 7% two year public school loans. HEAF's portfolio was never predominately trade school loans and the only reason it was insuring a large proportion of trade school loans in 1987 and 1988 was because of the Department of Education's denial of HEAF's various attempts to control its risk as documented in the attached statement.

There is also the implication that HEAF aggressively marketed to trade schools to encourage them to use HEAF as a guaranty agency and actively encouraged lenders to make loans only to trade schools. We can only attribute this perception to a misunderstanding of HEAF's commitment to assuring all eligible students access to a federal program and to a selected set of HEAF's lenders whose loan volume consisted of an extraordinary proportion of trade school loans.

HEAF was also responsive to requests from some lenders and colleges to provide state of the art services for universities such as Duke, the University of South Carolina, Clemson University and Northwestern. HEAF also participated in the development of special programs for law and medical schools. HEAF's current situation was caused by (a) the attractiveness to trade schools of our efficiency in processing loan applications, (b) our inability to attract low risk loans in amounts sufficient to offset the growing high risk loans HEAF was insuring, (c) the fact that students attending trade schools are defaulting at a higher rate than has been historically the case; and (d) our inability--when we say the imbalance in our portfolio occurring--to gain concurrence of the Department of Education to permit us to restrict the disproportionate mix of trade school loans despite our best efforts to do so.

Nevertheless, our efforts to compete for all loans did result in extraordinary improvements in the delivery of aid to students in this country. Had HEAF not engaged other agencies in competition for guarantees, students in South Carolina and Louisiana might still be underserved, students might still have to wait up to 12 weeks for loan processing--as was true in the early 80's--instead of hours today, on-line interactive computer systems to reduce work loads for financial aid officers and lenders might still be in their infancy, and special programs for special students might not exist. HEAF brought all these improvements to the Program while establishing the most effective compliance review team in the country. Our contributions to this Program have been extraordinary.

Summary and Closing

I and the other officers and employees of HEAF have mixed feelings about the hearings this Subcommittee has been holding on fraud and abuse in the Guaranteed Student Loan Program. On one hand, we are pleased that HEAF has been so often cited as the agency responsible for the identification of most of the large cases of fraud and abuse in the program and that HEAF has been the agency cited as most willing to act in accordance with what it has found. On the other hand, these hearings have the potential of characterizing the Guaranteed Student Loan Program as permeated by fraud and abuse and that HEAF's current financial circumstances were somehow the result of imprudent management decisions.

There is no denying that fraud and abuse have occurred in the program and some may be occurring today. Nevertheless, the cases your Subcommittee have identified demonstrate that enforcement efforts are effective, although not always as timely as any participant would like. Furthermore, no program the size of the Guaranteed Student Loan Program will escape fraud and abuses in the future, regrettable as such circumstances are.

We also believe that Congress should carefully consider all efforts to reduce fraud and abuse to avoid damaging the ability of the program to serve its purposes effectively and efficiently. We urge the Congress and the Department of Education to focus their resources on enforcement rather than prevention since focusing on the latter will limit opportunities for needy students to advance their socio-economic well-being through education and training.

Finally, we are pleased to report HEAF's record of accomplishment in assuring needy students access to loans; in improving the quality of services to schools, students and lenders; in saving taxpayers hundreds of millions of dollars in default costs; in identifying and eliminating large scale abuses in the program; and in providing high quality services to millions of students, and parents of students, over the years.

STATEMENT OF

RICHARD C. HAWK

CHAIRMAN

HIGHER EDUCATION ASSISTANCE FOUNDATION

(HEAF)

BEFORE THE

SUBCOMMITTEE ON EDUCATION, ARTS AND THE HUMANITIES

UNITED STATES SENATE

HEARING ON

PROBLEMS CONFRONTING THE HIGHER EDUCATION ASSISTANCE FOUNDATION

AUGUST 3, 1990

HEAF

Higher Education Assistance Foundation

STATEMENT

Richard C. Hawk, Chairman,
Higher Education Assistance Foundation

Before the
Senate Subcommittee on
Education, Arts and Humanities

August 3, 1990

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to appear before you today. Although the circumstances surrounding this hearing are difficult at best, I am pleased to be able to set the record straight about the Higher Education Assistance Foundation (HEAF) and the challenges and difficulties it faces. In my testimony today, I intend to provide you with a candid description of how our current difficulties evolved, the nature of those difficulties, what we have done to date to remedy the situation and what we have proposed to do to resolve the problem. Additionally, I will comment on the implications of the Foundation's situation for the entire student loan program and suggest some measures that may forestall future problems.

The origins of HEAF's difficulties

HEAF's current circumstances are the direct result of several factors:

- **HEAF's historic commitment to assure all eligible students -- regardless of their past educational achievements, economic circumstances, state of residence or the kind of school they were attending -- of equal access to the guaranteed student loan programs.**
- **The changing demographics of student borrowers in the loan program as grant support declined.**

- The development of state-of-the-art services for students, schools and lenders that proved most attractive to trade schools.
- The limited ability of guarantee agencies to finance the risk in their portfolios.
- The extraordinary abuses in the program by some schools and lenders, abuses that directly affected HEAF's financial strength.

The result of these events is that HEAF guaranteed an extraordinary proportion of trade school loans, half of which will default. This large proportion of trade school loans, about 31% of its current, outstanding portfolio, was insured by HEAF because of its commitment to assure all eligible, under-served students access to loans and its state-of-the-art computerized services. This began in the Spring of 1982 when Citibank, the Student Loan Marketing Association, HEAF and the United Negro College Fund jointly established a special loan program for students attending member institutions of the United Negro College Fund. A similar program for the League of United Latin American Citizens was established. Shortly thereafter the Hawkeye BanCorporation sought HEAF's services because of its dissatisfaction with the quality of services being provided by their guaranty agency and HEAF agreed to provide those services. Within a relatively short period of time, the major four-year institutions in South Carolina asked HEAF to serve their students because many could not obtain loans from the South Carolina agency and lender although the denied students were eligible to obtain loans under federal eligibility criteria. As representatives of under-served students and lenders approached HEAF for help, HEAF responded. Meanwhile, HEAF developed computerized processing systems that reduced the time required for students to obtain loans from nine to twelve weeks to a few days to provide improved services to students and schools. This advance in processing combined with HEAF's commitment to equal access proved most attractive to trade schools and, beginning in 1986, resulted in a skyrocketing volume of trade school loans.

As a consequence of its own efforts to provide state-of-the-art services to students, schools and lenders, HEAF guaranteed far more than its share of high-risk, high-default trade school loans. Furthermore, as it attempted to limit the eligibility of trade schools that wanted to begin using the HEAF services, it found that the law prohibited HEAF from imposing eligibility and certification criteria on schools more onerous that the Department's criteria.

Consequently HEAF deferred to the Department's Judgement about the eligibility of institutions to participate in the student loan programs. Moreover, large pockets of under-served students were created when other agencies did not honor this provision. Furthermore, the "antidiscrimination provisions" of the law, as interpreted by the Department of Education, stated that once a lender or school had established a relationship with HEAF, program requirements that were intended to assure equal access and due process made it almost impossible for HEAF to reduce the flow of high-risk loans it was required to guarantee.

These provisions and HEAF's state-of-the-art services resulted in adverse selection in HEAF's portfolio. Let me explain what I mean by adverse selection. In an effort to serve all its customers well, HEAF developed state-of-the art services for students, schools and lenders that, as it developed, proved particularly attractive to trade schools. HEAF simply provided better, more timely service than other guarantors. The quick turnaround HEAF provided to all its customers was particularly attractive to trade schools for cash flow reasons. Hence, they directed their students toward HEAF instead of to other guarantors. Also, in an effort to avoid these higher risk loans, certain state guarantors encouraged trade schools in their states to utilize HEAF instead.

The flow of high-risk loans to HEAF was further increased as several national lenders with whom HEAF had an existing relationship began making massive numbers of loans to trade school students. Those lenders used the HEAF guarantee because it was available nationwide, and because it was administratively more convenient and more efficient to use a single guarantor who could guarantee loans for students in nationwide. Banks no longer are constrained to lend only in a limited geographic area and larger lenders serve customers in many states. Since profit margins on student loans are narrow, many lenders seek to reduce expenses by using a single source of guarantees for students in many states. HEAF met that lender need but the nationwide scope of HEAF's operations left us vulnerable to increased risk when some of our customers began to send us large volumes of high-risk loans.

HEAF did *not* seek to guarantee high-risk, high-default loans as a way to generate fee income. That would have been reckless and self-destructive, since the fees we are allowed to charge are not sufficient to cover the risk on high-default loans. By a change in law in 1986, a guaranty agency may charge a guarantee fee no greater than 3% of the loan amount. Hence, a guaranty agency has limited flexibility to charge a fee that is commensurate with the risk of the loan. It would have made no sense whatsoever to deliberately seek to increase our fee income by guaranteeing high-risk loans, and that was in fact not our strategy.

We did seek to honor the equal-access requirements of the program, thus making the HEAF guarantee available to students at trade schools as well as four-year schools. Our intentions were honorable, and we believe they were consistent with what Congress intended. However, because market forces directed a high volume of high-risk loans our way, HEAF guaranteed a disproportionate share of loans that default at a high rate, and the results were financially very detrimental to us. If the loans guaranteed by HEAF to students at trade schools were more evenly divided among guarantee agencies, all our agencies would jointly have the financial resources to cover all default expenses.

Why didn't HEAF simply stop issuing guarantees on the higher risk loans? The answer is that we tried, but that the options we believed were available to us were denied us by the Department's interpretation of the law and regulation.

Chronology of management action to reduce the volume of high-risk loans

The percentage of high-risk trade school loans in HEAF's guarantee portfolio began to rise in the early 1980s, from 8% in 1981, 10% in 1982 and 13% in 1983, to 22% in 1984. By 1985, when this trend began to threaten the health of our guarantee portfolio, HEAF began to take steps to correct the disproportionate number of trade school loans in the portfolio. Our first step was to encourage lenders to attempt to generate more balanced loan portfolios. At the same time, we encouraged secondary market organizations to stop paying premiums to acquire trade school loans.

By late in 1986, it was apparent that additional, more drastic measures would be needed if HEAF was to curtail the growing imbalance in its portfolio. Hence, management took several actions to deal with this emerging trend. These actions included:

1. In a departure from the industry standard, the Foundation revised its guarantee fee structure in April, 1987 to charge the maximum rate permitted by law (3%) for loans to students attending trade schools and offered its guarantee at no charge to borrowers attending four-year colleges and universities. Unfortunately, this rate structure had no discernible impact on the portfolio mix.

2. Also in April, 1987, the Foundation adopted a policy that required borrowers attending schools with a historical default rate of 40 percent or more to secure cosigners for their loans. This requirement had to be rescinded after the U.S. Department of Education advised us that such a policy might be interpreted to be "discriminatory".

3. Early in 1988, the Foundation moved to cancel its agreements with several major lenders who were bringing the Foundation $1.5 billion per year in loan portfolios which were more than 90% high risk paper. This effort was chilled by the Department of Education's expressed view that the Foundation would need to proceed under so-called "Limitation, Suspension, and Termination" procedures to cancel those agreements. In HEAF's view, it could not use L,S and T actions in the absence of violations of law or regulations, so it began searching for another approach.

4. The Foundation then proposed to review the eligibility of each school to continue use of the Foundation's guarantee after a future date. Again, the Department of Education determined that full "Limitation, Suspension, and Termination" procedures would need to be followed for each of the hundreds of schools which might not be approved under this approach. Again, no timely results could be obtained.

5. Fortunately, the Department of Education came up with an effective solution in June, 1988. The Department agreed that a guarantor may restrict access to its guarantee by geographic region. This ruling allowed us to evaluate our business on a state-by-state basis. Eighteen states were identified whose 1987-88 loan volume consisted of more than 80% high risk paper, and we announced our intent to withdraw from those states as of July 15, 1988.

6. Between March, 1988 and July, 1988 HEAF guaranteed about $500 million in loans from the lenders who were subjected to the actions in 3. above, which resulted in a unrecoverable cost to HEAF of $50 million.

In withdrawing from the 18 states, the Foundation gave up more than $1 billion per year in loan volume, with 93% of that volume representing other than four-year institutions. The objective sought by management was to restore a balance portfolio mix where no more than 40% of new guarantee volume came from trade schools.

The decision to withdraw was made difficult by three major considerations:

1. The loan volume abandoned represented at least $30 million per year in cash receipts as well as at least $10 million per year in Federal Administrative Cost Allowance. The Foundation would experience two years of reduced cash receipts before it began to realize the benefits of substantially reduced default expense.

2. Some valued customers would be inconvenienced, particularly regional and national lenders who simply did not want to deal with a variety of local guarantors.

3. Even though management was confident that the withdrawal strengthened the Foundation's long term viability, it was felt that others in the industry--primarily competitors--would draw attention to the short term negative financial impact.

The actual results secured by our action were dramatic and even more beneficial than anticipated. The proportion of trade school loans in our insured portfolio is rapidly dropping because the proportion of trade school loans which we are now insuring is less than 30% of all insured loans. Today our portfolio contains about $3 billion in insured loans for trade school students, $400 million of which are in "in-school or grace." The remainder are in repayment.

As you have seen, HEAF has been endeavoring to resolve the rapidly growing imbalance in its portfolio for five years now, but we have been hampered by unfortunate interpretations of the regulations and the inflexibility that has been built into the program. Even a guarantee agency with extremely vigilant management such as HEAF's is limited in the steps it can take to control the lenders or schools that are the source of the high-risk paper.

Current situation

An additional issue I want to address forthrightly is the view that HEAF's growth necessarily was at the expense of quality, and that thus excessive default rates were an inevitable byproduct. The facts simply do not support this view. While HEAF has indeed achieved significant economies of scale, such economies have not come from diminished effort.

- HEAF subjects each loan application to over 500 of edit criteria before issuing a guarantee. Even so, applications are typically processed within 24 hours.
- HEAF's default-aversion programs "cure" more than 60% of delinquencies reported to us by our lenders.
- By utilizing more than 200 in-house collectors, 12 collection agencies and a national network of law firms, HEAF will collect more than $100 million in defaulted loans this fiscal year.
- HEAF's dedicated compliance staff has identified program violations and imposed liabilities problems and imposed penalties that returned $2 million to the program during the past fiscal year and resulted in "L,S and T actions against 35 schools.
- HEAF's claims examiners reject almost 15% of submitted claims as a result of detecting violations of due diligence requirements and impose interest limitations that save the program an average of $750,000 per month.
- Despite this thoroughness, our cost efficiency, according to Department of Education data (defined as operating expense less collection costs, divided by the number of loans guaranteed) is greater than all but four other guaranty agencies.

A dozen representatives of the Department of Education and the Office of Management and Budget spent last week critically examining HEAF operations on site. We are confident that they will confirm the high standards of performance to which HEAF adheres.

Mr. Chairman, my remarks in this regard are designed to meet two objectives:

First, I believe that the management and staff of the Foundation deserve to have me respond to the comments of recent weeks that reflect on their competence and dedication. Their performance is now, and has always been, the finest of any guaranty agency participating in the program. HEAF is one of the most efficient agencies in the country, with an exceptional record of developing innovative and needed services for students and schools, of recovering defaulted student loans and of uncovering and ending abuses in the Guaranteed Student Loan Program.
Second, HEAF's demonstrated efficiency and effectiveness suggests that its technological resources and its experienced and dedicated staff are valuable to the continued stability and viability of the loan program.

Despite the immediate difficulties we face, our situation can best be summarized as follows:

- HEAF's action of July 1988 to curtail a growing portfolio imbalance was indeed successful, and our current-year guarantee volume consists primarily of highly desirable college and university loans. In other words, the required corrective action was taken two years ago, and it has clearly succeeded.

- The financial stress now faced by the Foundation is not part of a continuing downward trend. Rather it is the tail-end of a period of reduced revenues and expanded costs as we digest the last of the high-risk loans guaranteed before corrective action was taken in 1988.

- An additional burden on our reserves in the short term is posed by the imminent resolution of a long-standing matter relating to the Bank of America. This matter surfaced in June of 1988, when HEAF's compliance team discovered major irregularities in the servicing of a loan portfolio for which the Bank of America serves as trustee on behalf of the California Student Loan Finance

Corporation. HEAF immediately reported its findings to the Inspector General of the Department of Education. Following a joint review, the Department directed HEAF to suspend all claim payments from this portfolio. Over the past two years, intensive negotiations have taken place between the Department, the Bank of America, HEAF and the two other guarantors involved to identify a fair and mutually acceptable resolution of this situation. HEAF guaranteed $565 million of this $1.1-billion portfolio, and the default rate is expected to be between 60% and 75%. Under the proposed settlement agreement, these figures pose extraordinary potential cost and cash flow consequences for HEAF.

- HEAF was in the process of pursuing a plan to transfer certain loans to, and ultimately to merge with, the Nebraska Student Loan Program (NSLP). Because it is a new guaranty agency, Nebraska temporarily receives 100% reinsurance from the federal government regardless of the percentage of default claims which it submits to the Department. The merger would have allowed HEAF to receive 100% reinsurance for the next year, which should have been enough time for the last of the extremely high-default portfolio to work its way through the system. At that point in time, the long-term correction created by the new portfolio mix would have taken effect, and the problem would have been solved. However, the Department raised objections to our proposal.

We disagree with the Department on the legality and viability of our proposed transfer of loans to, and merger with NSLP, and we do not believe it is necessary for the Department to seek an alternative solution. Having said that, we will continue to provide our full cooperation as they explore other options. Our goals in those deliberations will be to ensure that the long-term viability of the Guaranteed Student Loan Program is protected and that the Foundation's employees who have served so expertly and diligently will be treated with fairness.

Implications for the future of the program

The Higher Education Assistance Foundation was created nearly a decade and a half ago out of a belief in the goals of the Guaranteed Student Loan Program. We all share a wish that the program continue meeting its laudable goals. As you view HEAF's situation today, it is essential that you consider its implications for the future success of the entire program.

Preserving assets

A central goal in the resolution of the situation we face is the protection and preservation of two great assets--our staff and our technological resources. We are proud beyond measure of the manner in which, under the most trying of times, our loyal, dedicated and incredibly talented team has managed its responsibilities. It is a reaction we knew we could expect, since they are the ones who have made us one of the most respected and efficient guaranty agencies in the country. Their dedication to our mission, and to the students, schools and lenders we serve, has been unwavering.

Our computer system is unparalleled in the industry. We have invested a great deal of effort in the development, construction and implementation of this system over the past three years, and that investment has paid huge returns in the form of service that is both responsive and responsible. It is responsive in that it conforms easily and efficiently to the needs of lenders, both large and small, permitting easy customizing; it is responsible in that it has built-in checks and edits that virtually eliminate programmatic violations and data inconsistencies. It has allowed the Foundation to issue guarantees quickly, while eliminating compliance errors. These technological and human resources, combined with our infrastructure, procedures and operating standards, form a highly effective and efficient operating unit that would be time-consuming, expensive and difficult to replicate.

If the Guaranteed Student Loan Program continues at approximately its present level of activity--and there is every reason to believe that it will--the nation will continue to need the Foundation's capacity if we are to ensure continued service levels. The long-term cost of re-establishing this pool of experience, expertise and dedication would be high, not to mention altogether unnecessary.

Creating new opportunities

If the growing number of high-risk trade school loan guarantees is at the root of HEAF's financial woes, then the solution may seem obvious to some: reduce or eliminate the federally backed guarantee for loans to students at such schools. Yet to take such a step would be to deny thousands of students the opportunity to improve their standard of living and make a greater contribution to society as a whole.

If a student wishes to study to be a court reporter, a diesel mechanic or a computer technician, he or she has as much right to federally sponsored student lending as a student who wishes to study physics, English or sociology. Society values both categories of students equally, and the Guaranteed Student Loan Program must continue to do likewise. Clearly, additional steps will need to be taken to weed out the illegitimate trade schools that prey upon taxpayers and students alike. Yet the program must at the same time continue to allow for the legitimate interests of post-secondary students whose needs are not met by four-year colleges and universities.

Providing flexibility for guarantors

Another lesson of HEAF's experience over the past several years is that, while a great deal of risk is laid at the feet of the nation's guaranty agencies, little control over the level of that risk is placed in their hands. Unlike a typical insurance program, or for that matter a typical lending program, the risks and the rewards are not distributed in a way that provides an incentive both to serve a broad cross-section of students and, at the same time, to remain in viable financial condition. Some possible improvements:

- The existing trigger formula, which was designed for a different era, could be replaced with a formula that provides greater, rather than lesser, reinsurance to agencies that bear the burden of an unfavorable mix of loans. Rigorous controls could be instituted to discourage lack of diligence in weeding out fraudulent and irresponsible lending practices.

- The ceiling on the guarantee fee could be eliminated, granting each guarantor the opportunity to establish a fee at the level necessary to cover losses.

- Another possible solution would be to prohibit guarantors from guaranteeing loans for students who are neither residents nor attending school in a state in which they are the designated guarantee agency. The disadvantage of this alternative is the inconvenience it offers to lenders doing business across state lines, yet it would help avoid the high concentration of trade school loans from disparate sources from being guaranteed by a single agency.

Closing

Thank you for giving us this opportunity to present our perspective on this important matter. As always, you may expect our full cooperation and assistance as you seek to resolve issues for the benefit of the schools, students and lenders the Program serves.

RESPONSES OF
GARRY HAYS
PRESIDENT
HIGHER EDUCATION ASSISTANCE FOUNDATION
TO THE OCTOBER 18, 1990 QUESTIONS OF THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Q. To what extent did HEAF as guarantee agency for FITCO, exchange information with the California State Banking Department, which was the State regulator of FITCO? Who did you Exchange pertinent information with? Who did you notify when you discovered problems at FITCO?

A. HEAF did not receive information from or provide information to the California State Banking Department with regard to FITCO until HEAF's program review in April of 1989. HEAF notified the Department of Education of problems in early 1989 when FITCO began delaying disbursements past their scheduled dates.

Q. What considerations are given before your guarantee agency decides to give a lender identification number to a lender?

A. HEAF complies with the prescriptive §428(b)(1)(U) of the Higher Education Act of 1965, as amended, which requires it to agree to provide for the eligibility under reasonable criteria of all financial institutions that meet the definition of an "eligible lender" as defined in §435(d) of the Higher Education Act of 1965, as amended. Accordingly, HEAF's considerations are that the lender is located in its "area of service" and meets one of the following definitions:

> ...*(A) a National or state chartered bank, a mutual savings bank, a savings and loan association, a stock savings bank, a trust company, or a credit union which--*
>
> *(i) is subject to examination and supervision by an agency of the United*

States or of the State in which its principal place of operation is established, and

(ii) does not have as its primary consumer credit function the making or holding of loans made to students under this part unless (I) it is a bank which is wholly owned by a State, (II) it is a single wholly owned subsidiary of a bank holding company which does not have as its primary consumer credit function the making or holding of loans made to students under this part, or (III) it is a trust company which makes student loans as a trustee pursuant to an express trust and which operated as a lender under this part prior to January 1, 1981;

(B) a pension fund as defined in the Employee Retirement Income Security Act;

(C) an insurance company which is subject to examination and supervision by an agency of the United States or a State;

(D) in any State, a single agency of the State or a single nonprofit private agency designated by the State;

(E) an eligible institution which meets the requirements of paragraphs [1 through 5 of §435(d)];

(F) for purposes only of purchasing and holding loans made by other lenders under this part, the Student Loan Marketing Association or an agency of any State functioning as a secondary market;

(G) for purposes of making loans under sections 428A(d), 428B(d), 428C, and 439(q), the Student Loan Marketing Association;

(H) for purposes of making loans under sections 428(h) and 428(j), a guaranty agency;

> *(I) a Rural Rehabilitation Corporation, or its successor agency, which has received Federal funds under Public Law 499, Eighty-first Congress (64 Stat. 98(1950)); and*
>
> *(J) for the purpose of making loans under section 428C, any nonprofit private agency functioning in any State as a secondary market....*

Q. What factors caused the immense growth and competition in the secondary markets and guarantee agencies in the mid-1980's?

A. The question requires two answers, one concerning growth in secondary markets and the other concerning competition among guarantee agencies.

According to the U.S. Department of Education's "FY 1988 Guaranteed Student Loan Data Book," the most rapid growth of the student loan program occurred during the period between 1972 and 1981, followed by a decline in volume the following year. Modest growth occurred between 1982 and 1985 and a decline in volume occurred the following two years. Between 1987 and 1988 the growth rate in the programs increased rapidly again, almost matching the period of most rapid growth between 1978 and 1981. Although we have been unable to document the growth of secondary markets as suggested in the question, their growth would follow the patterns of annual loan volumes as secondary markets met lenders' needs for liquidity and secondary market outlets. Growth in the student loan programs can be attributed to a number of interacting factors including the rising cost of education and significant changes in the eligibility rules governing the program which increased loan usage. Changes made by Congress in the mid-1980's increased the loan amounts available to students, broadened the availability of the loan programs among schools and significantly increased the eligibility of students for SLS loans.

HEAF's success in increasing efficiency and turnaround time while providing a high level of service occurred at the same time as the tremendous growth in the loan program. The innovative services offered by HEAF caused other guarantee agencies to increase their efforts to serve their customers, leading to competition among the agencies. Almost simultaneously, the banking industry's traditional geographical constraints were being removed by changes in state and federal laws allowing banks to evolve through mergers, acquisitions and expansion to a "regional" or "national" status. Such banks sought guaranty services that would cross state lines with them thereby generating greater competition among guaranty agencies. Hence, three factors were responsible for the growth of competition among agencies: (a) underserved schools and students, (b) lenders's dissatisfaction with the quality of services they were receiving, and (c) profound changes in the banking industry that occurred during the 80's.

Q. Do you believe we need over 50 guarantee agencies?

A. As this is being prepared there are 47 guarantee agencies. It is our belief that the number of agencies should be determined by the marketplace, i.e., those able to deliver the best level of services at competitive cost should be "selected" to continue by students, schools and lenders.

Q. Why did HEAF so aggressively court proprietary trade schools in the early years? Was there no indication that these loans default at a higher rate and that these programs are more susceptible to fraud and abuse than other schools?

A. HEAF *never* aggressively courted proprietary trade schools to the exclusion of other schools. The reason HEAF never courted proprietary trade schools was the high default rate associated with such schools. Some lenders that relied on HEAF's insurance aggressively courted proprietary trade schools contrary to HEAF's interest and constant, but unsuccessful, efforts to end relationships with such lenders. The persistence of the myth that HEAF aggressively courted proprietary trade schools is baffling in view of the lack of any evidence that would substantiate the myth.

HEAF did, however, attempt to deal aggressively with the fraud and abuse by increasing the number of program reviews it performed and actively pursuing limitation, suspension or termination actions when warranted.

Q. How many times has HEAF hit the 80% trigger rate on reinsurance from the

Department of Education? When that occurred in the past, how did HEAF meet the additional financial burden?

A. HEAF hit the 80% trigger rate in some of its designated states in each of the last three fiscal years. In each case, the difference between the insurance paid to lenders and reinsurance received from the federal government came from reserves accumulated for this purpose over the years of HEAF's existence. Since its inception, HEAF has paid almost $212 million more to lenders than it has received in reinsurance from the government.

Q. What, if any, business relationship existed between HEAF or its associated companies and United Education and Software?

A. There was no business relationship in the usual sense of the term between HEAF or HEMAR organizations and UES. HEAF's business contacts with United Education and Software (UES) related solely to the provision of guarantees to students attending UES schools and to the servicing of students loans performed by UES on behalf of Bank of America. These relationships were no different than the normal business relationships between HEAF and other servicers or schools.

Q. What, if any, business relationship existed between HEAF or its associated companies and the California Student Loan Finance Corporation?

A. The only business relationship between HEAF and its related companies and the California Student Loan Finance Corporation (CSLFC) was the lender agreement between HEAF and Bank of America, as trustee for CSLFC, under which HEAF agreed to honor its insurance on loans Bank of America bought as trustee for CSLFC from lenders that used HEAF's insurance. Again, this relationship was no different than HEAF's relationship with any other secondary markets.

Q. Did you or anyone in your office ever receive any indication that you or HEAF should not aid this Subcommittee's investigation from the Department of Education or any of its employees?

A. No.

Q. There are several questions regarding HEAF's policies, procedures, and/or practices, which are prompted by the testimony presented by Tommy Wayne Downs during our September 12th and 13th hearings. Mr. Downs said that it took as little as six working days for HEAF to turn around a loan, in contrast to the Tennessee guarantee agency, which he said at best could provide the same service in six weeks. As far as HEAF goes, is what Mr. Downs said accurate? If so, how do you account for the differences between HEAF and its Tennessee counterpart?

A. HEAF's state-of-the-art computer systems have the capacity to approve and issue loan guarantees in a matter of hours and in full compliance with all applicable laws and regulations. If the Tennessee guarantee agency's best "turnaround" time is six weeks, it is due solely to its considerably less efficient operations.

Q. Is six days a sufficient amount of time to review an application so as to assure, for example, that it does not contain any important misrepresentations?

A. Yes, as "sufficient" is defined by law and regulation, government agencies such as the General Accounting Office, the Inspector General of the U.S. Department of Education, and program officials of the U.S. Department of Education, have routinely judged HEAF's reviews of data on loan applications in full compliance with the law and regulations. As stated in our formal testimony before the Subcommittee, HEAF's systems and personnel perform over 500 separate checks of data on each application. Equally important is the role of the financial aid office of schools in certifying applications of enrolled students.

Additional edits can be performed but we judge them to be largely ineffective in eliminating fraud by clever persons intent on defrauding the program, so costly as to be wasteful of federal and borrower fees, and so time consuming as to be an obstacle to educational opportunity.

Q. What is your response to Mr. Downs' testimony that HEAF approved guaranteed student loan applications he submitted, even after HEAF employees knew he was under investigation for obtaining fraudulent loans at the Rogers/Guideliners School in Tennessee? Did this occur and, if so, how could such a thing take place?

A. It is not true that loan applications continued to be processed after HEAF knew of the investigation at Rogers. On April 20, 1987, HEAF was notified of a serious problem at the Rogers School by the Atlanta Office of Inspector General. We immediately stopped processing applications and loan checks and started cooperating with FBI and OIG agents.

Meanwhile, in November, 1987, the Harrisburg Barber School started processing student loans through HEAF. However, there is no information in the school's file to show that Tom Downs was the owner of this school in Pennsylvania. The school's program participation agreement is signed by Joseph Francis, Chairman of the Board, and Carol Sperry of the Department of Education. It was not until the irregularities found on certain applications were reported to HEAF's Compliance department that the connection to Tom Downs was made. The HEAF employee discovered that the certifying school official for these applications was named Cathleen Downs, possibly related to Tom Downs, and contacted the Office of Inspector General on September 28, 1988. At that point in time, HEAF had not processed any guarantees for this school since July, 1988. Still, the OIG specifically requested that HEAF not take any adverse action, such as suspending processing or beginning limitation, suspension or termination (LS&T) action, so as not to alert the school of an investigation.

Q. Mr. Downs indicated that, based on his experience, one of the reasons it was so easy to get HEAF approval of a loan application was that little, if any, verification was done regarding the information provided on it. Does HEAF verify information on an application form and, if so what type of information is verified and what does the verification entail?

A. Mr. Downs confuses efficiency with laxity in verifying information. As stated in our formal testimony and in answer to a previous question, HEAF performs over 500 edits of data on loan applications. Your question seems to be directed at efforts guarantee agencies and lenders make to verify school provided data regarding the eligibility of applicants for loans and to verify the identity of borrowers. In the absence of direct, and we mean direct, access to school records, lenders and agencies must rely on school officials' certifications about school related data that determine the eligibility of applicants for loans. Unscrupulous school officials can provide fraudulent data on loan applications which will cause lenders and agencies to provide financial aid. In addition, efforts are made to make sure notices of loan guarantees and enrollment verifications are directed to persons other that the officials of schools that "certify" applications. However, in cases such as Mr. Downs who was intent on defrauding the program, such efforts to prevent error and fraud can be defeated.

Q. Mr. Downs further indicated that he continues to believe it would be easy to do the same thing he did before, because HEAF and other involved agencies and institutions cannot, for example, even verify Social Security numbers on an application. Is this true and, if so, what would you recommend be done about the problem that may exist?

A. HEAF and other agencies do perform edits on Social Security numbers to determine their efficacy using mathematical algorithms provided by the Social Security Administration. The validity of individual Social Security numbers cannot be verified directly with the Social Security Administration. Such verification would not absolutely prevent fraud since Social Security numbers can be fraudulently obtained. We have no recommendations concerning ways to improve the verification of Social Security numbers.

Q. In response to a question, Mr. Downs said that he believed that the Federal student loan program would be "killed" if schools were required to assume some financial risk in connection with guaranteed loans it was seeking. Do you agree or disagree? Is there any way to hold schools more accountable for the loans they generate?

A. We doubt that the student loan program would be "killed" but its use would be sharply altered since it would be used only by institutions that could find a way to finance their future default costs or those that serve students who are least likely to default. As a result, schools with a high "profit margin" would have continued access (they simply would make somewhat less profit) and schools with students who do not really need assistance would have access as well.

Q. Does HEAF have any procedure that will generate increased scrutiny of a school's loan applications if, for example, a significant increase in volume occurs from one month to the next and/or gradually over a period of time? If not, why not?

A. HEAF produces activity reports monthly, quarterly and annually for schools and lenders. The report shows the dollar volume of loans processed for a school in the previous period and which lenders have made the loans. These reports are used by HEAF management to determine both short-term and long-term trends. The Compliance department makes extensive use of such reports in order to select schools and lenders for program reviews.

Q. Does HEAF have any procedure to periodically verify the ownership status of a school obtaining loans under its aegis? What is HEAF's policy regarding the reporting of changes in ownership? If documentary information is called for, is such information verified?

A. HEAF verifies ownership of schools as it reviews schools and closely follows reports of ownership changes provided by the U.S. Department of Education. As it is informed about changes in ownership, HEAF relays such information to the U.S. Department of Education. HEAF does not routinely verify changes in ownership because it is unclear that such efforts would reveal any usable information in program administration.

Q. In your letter of September 20, 1990, you state (on p. 1) that "if HEAF procedures were as lax as Mr. Downs has suggested, he would not be in prison today." Later in the letter (P. 2), you state that HEAF's "aggressive policies and procedures designed to prevent and detect fraud have worked well, as indicated by the fact that Mr. Downs is in prison. In effect, you appear to be taking credit for the fact that Mr. Downs was caught. However, according to Mr. Downs and our Subcommittee files, Mr. Downs was caught in the first instance as a result of a call to HEAF from is unsuspecting secretary and, in the second case, his fraudulent scheme was discovered by an employee of a secondary market purchaser. Is that accurate, to your knowledge?

A. In the first instance, the case of the Rogers School of Barbering, HEAF was notified by the Office of Inspector General and cooperated with the FBI and OIG in the investigation. Original checks and loan applications were provided promptly, and special reports were run which aided the investigation. It was never stated that HEAF caught Mr. Downs in his first fraudulent scheme, but HEAF's cooperation with authorities assisted in his conviction in Tennessee.

In the second fraudulent scheme, the case of the Harrisburg Barber School, it was HEAF that identified Mr. Downs as the perpetrator of a scam that was reported by the secondary market. The secondary market was following HEAF's own guidelines when it suspected something irregular with a number of loans it had bought from a bank in Pennsylvania. The employee at the secondary market did exactly what HEAF Compliance asks of lenders when it notices something potentially fraudulent and called the Compliance department at HEAF. Alerted to the problem, the Compliance employee asked questions and made the discovery that the certifying official on the suspicious loan applications was named Cathleen Downs. Upon recognizing this name, HEAF immediately contacted the OIG in Philadelphia.

TESTIMONY OF
DR. SAMUEL M. KIPP, III
EXECUTIVE DIRECTOR, CALIFORNIA STUDENT AID COMMISSION

SUBMITTED TO THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
UNITED STATES SENATE
SEPTEMBER 25, 1990

P.O. Box 510845
Sacramento, CA 94245-0845

TESTIMONY OF
DR. SAMUEL M. KIPP, III
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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to provide information I hope will be of assistance to the Senate Permanent Subcommittee on Investigations during its examination of the potential for fraud and abuse in the federal guaranteed student loan programs.

I am Dr. Samuel M. Kipp, III. As a past faculty member at a major university, I have observed first hand the hopes and dreams which compel many Americans to seek a better life through higher education. My later work as a postsecondary education policy specialist reinforced my understanding of the important role which financial aid plays in making these dreams a reality. My current position as executive director of the California Student Aid Commission has made me appreciate the tremendous contributions of our current grant and loan programs and all too familiar with the unfortunate plight of those students who are most frequently the victims of malfeasance when it occurs in the educational loan program. I have long advocated reforms which would eliminate the parasites which have attached themselves to an otherwise sound, healthy and worthwhile student loan program.

This is not just rhetoric. In California, whether the wrongdoing has been on the part of students, schools or lenders, we have been willing to take the necessary compliance action. In the first month after I became Director in 1986, we took an administrative action to terminate the first school ever removed from the California loan program.

Half of all Termination Actions in the Nation

Since then, 30 additional schools and one lender in the state have been limited, suspended or terminated from the student loan program. The number may appear modest, but it represents half of all the termination actions taken in the United States since the loan program began. Most of the violations are discovered during one of the Student Aid Commission's 140 annual program audits. In every instance, the school removed from the program was a for-profit vocational school. The most frequently cited violations which established a continuing pattern of administrative failure on the part of the schools were unmade or untimely refunds, certifying ineligible loans and failure to establish students' financial need or ability to benefit.

The lender, First Independent Trust Company (FITCO), was once one of the largest lenders in California and the nation, having made over $519 million in student loans guaranteed by the Student Aid Commission and some $1.5 billion nationally. FITCO was terminated by the Commission for failure to pay at least $4.5 million in loan origination fees owed USDE, failure to make millions worth of timely refunds to borrowers and other serious violations.

Students--or more often those posing as students--as well as school owners or officials who have attempted to defraud the program have been caught, directed to pay restitution, and often sent to jail because of cases assembled by the Student Aid Commission's fraud investigators.

These actions have no doubt given rise to a "get tough" reputation for the California Student Aid Commission. We do not mind that characterization at all. The Commission is committed to taking an aggressive, no nonsense approach to protecting students and restoring public confidence in the integrity of the loan programs. The Commission makes no secret that, during the past five years, it has nearly tripled its compliance audit staff, doubled the personnel assigned to investigations and introduced numerous innovative steps to reduce defaults and enhance program integrity.

Dramatically Changing Student Loan Program

These adjustments have been necessary in the face of a dramatically changing student loan program. To better understand where we are today and why, let me briefly review the program dynamics in place when I became executive director of the California Student Aid Commission in January 1986.

While student loan borrowing volumes had fluctuated since the program's origin in 1966, usually in response to various legislative and regulatory changes, several factors set the stage for unprecedented, explosive growth in the volume of student loans during the late 1980's.

Under the Higher Education Amendments of 1986, annual and aggregate student loan limits in both the Stafford and SLS programs were increased. While demonstrated need and multiple disbursement somewhat tightened eligibility in the Stafford program, other provisions made the application process for the Supplemental Loans for Students (SLS) program extremely easy and attractive. Taken together, these factors combined to create an ideal vehicle for exponential growth in borrowing at vocational schools. This was further fueled by simultaneous growth in the national activities of multi-state guarantors and growing competition among student loan secondary markets. By 1987, the Higher Education Assistance Foundation (HEAF) and United Student Aid Funds (USAF) became the largest guarantors in the program. Together they accounted for nearly 40 percent of the nation's total loan volume.

Unfortunately in this era of expansion, some smaller, under-capitalized financial institutions extended their student lending well beyond their financial means and administrative capabilities. After declining nearly four percent the previous year, national student loan volume jumped nearly 14 percent in fiscal year 1987 to $9.7 billion. The next year, the volume increased over 21 percent to $11.8 billion. A near tripling of SLS borrowing accounted for most of the fiscal year 1988 increase, with for-profit vocational schools responsible for the majority of the growth in SLS loan volume.

Accompanying this growth in volume was a growing national concern over rising student loan defaults. Hearing a contradictory congressional chorus which called for unlimited access to student loans and a curb on defaults, USDE elected to view defaults as the product of reluctance on the part of lenders and guarantee agencies to diligently pursue student loan collections. This "defaulters as deadbeats" myth gave rise to a cumbersome, mechanical approach to due diligence collection requirements which failed to squarely face the real problems in the program. The vast majority of defaulters could not pay rather than would not pay. Furthermore, they could not pay because they were too often victims of schools that failed to deliver the quality education, training and jobs they promised.

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Stage Set for Disaster

In this way the stage was set for occasional disasters as well as ongoing structural problems: expanded loan limits; proliferation of low- and no-quality schools established for the primary purpose of collecting student loan proceeds; intense national competition by some lenders and guarantors to accumulate loan volume with too little attention given to portfolio balance, program compliance or school quality; and some student loan secondary markets hungry to provide liquidity to lenders for whatever loans they could book as assets. Under these circumstances, the worst was bound to happen and, in California and several other places, it did.

First Independent Trust Company of Sacramento, California, became a lender in the federal Guaranteed Student Loan program in 1980. FITCO made loans primarily to for-profit vocational schools both in and outside of California using guarantees from both the California Student Aid Commission and HEAF. In 1985, FITCO volume was ranked 14th in the nation. Then fueled by its own ambitions, large forward-purchasing agreements from the California Student Loan Finance Corporation (CSLFC), an explosive demand for loans from out-of-state proprietary schools, and the ready availability of HEAF guarantees, tiny FITCO quickly rose to become one of the very largest originating lenders in the country by the late 1980s.

A portion of the loans originated by FITCO were for students attending a chain of vocational schools operated by United Education and Software (UES) company. UES, based in California, operated schools throughout the country. In addition to its trade schools, UES also originated loans for FITCO and ran a student loan processing center and contracted with CSLFC to service CSLFC's portfolio of student loans.

FITCO did not hold its student loans long after origination, selling them almost immediately to a secondary market. The vast majority were purchased by CSLFC, a not-for-profit corporation established in the state to provide liquidity for the California student loan market. CSLFC sought and received an amendment to its original plan for doing business in 1986 to also purchase what it promised would be a small number of loans made to students outside the state. In fact, most of its dramatic growth after that date stemmed from the rapid acquisition of out-of-state loans.

This combination proved to be the formula for explosive, nearly unchecked growth in FITCO loan origination during the mid 1980's.

FITCO originated only 216 loans for a little over $500,000 under the Student Aid Commission's guarantee in FY 1980, the year it entered the state's program. Five years later, it originated nearly 36,000 loans for about $92 million; then almost $110 million in FY 1986; and reaching a high of $148 million in FY 1987 under the Commission's guarantee. At the same time FITCO originated hundreds of millions in loans under the HEAF guarantee.

A Commission compliance audit in November 1987 resulted in the citation of FITCO for failure to pay over $13 million in loan origination fees owed USDE to make timely refunds owed students, and other critical administrative errors.

In August 1988, a USDE report, based on a joint audit by the Commission, HEAF and USDE identified some $600 million in student loans held by CSLFC which had been compromised severely by the faulty servicing provided by UES. The shock waves of this tragic failure have reverberated through international credit markets, the operations of almost all secondary markets, lenders and the entire student loan program.

FITCO Terminated from Loan Program

The Commission conducted a follow-up compliance audit of FITCO in February 1989. It revealed serious problems which included providing computers and software to schools as an incentive to process FITCO loans, the failure to pay additional millions in loan origination fees owed USDE, to make timely refunds, or to notify current holders of its loan cancellations. Based on this evidence of continuing administrative failure, the Commission terminated FITCO from the program on April 21, 1989. The California Banking Department seized FITCO on May 19, 1989, and initiated liquidation of the lender's assets.

The consequences of the FITCO/CELFC/UES failure--in which a corporation that owns and operates schools also originates loans for a lender which, in turn, quickly sells those loans to a secondary market that has contracted with the same corporation to service its loans--had a profound impact on the student loan program. Costs for credit support for student loan secondary market bond issues were raised to reflect the great risks of student lending. Tighter restrictions on portfolio composition and secondary market purchases affected primary lending and led to more limited access to loans for some students. The total financial losses, not yet fully known, are already staggering. But the greatest victims are the hundreds of thousands of students left with debts, bad credit ratings and few if any marketable skills.

Having shared details of the FITCO mess with you, I must emphasize that it is neither indicative nor representative of the student loan program as a whole. It would be a mistake to confuse the excesses of the program with its essence. The vast majority of student loan borrowers get good educations at quality institutions and are able and willing to repay their loans. Most lenders follow sound lending practices and adhere to program requirements. However, the day is long past for encouraging indiscriminate borrowing in the student loan program under the pretense of championing access. Congress must recognize once and for all that student access to anything less than educational quality is no access at all. The issue is not institutions that serve poor students, the problem is institutions that serve students poorly.

Improvements, Direct Action Needed

Guarantee agencies have a critical role to play. They must be willing to provide the services and oversight that are central to the daily operations and to the overall health of the loan program. They must be prepared to "get tough" and take the necessary compliance action to uncover and eliminate fraud or abuse. This will undoubtedly mean taking risks. If aggressive action to protect and improve the program lead on occasion to being sued, so be it. Of equal or perhaps greater importance, guarantee agencies need to work with their states to tighten licensing requirements for vocational schools to assure greater consumer protection. California has already taken such steps.

USDE must also take immediate steps to ensure that program requirements limit eligibility only to qualified educational institutions. Tightening front-end eligibility requirements is far better than waiting for substandard schools to victimize more students. Thousands of lives have already been damaged by inadequate eligibility standards. In the absence of effective Congressional or departmental action, back-end compliance actions are essential, but they are not a satisfactory long-term solution.

The marketplace is also providing part of the correction: secondary markets can no longer purchase and support unbalanced student loan portfolios. The financial margins in the loan program are too narrow and the risks and penalties too great for lenders to engage in open door lending or originate too high a proportion of risky loans. Furthermore, lenders cannot afford to use guarantee agencies with portfolios that are out of balance.

Congressional Budget Reconciliation is already producing substantial benefits and dramatic program savings. Despite some misleading rhetoric about access, we should stay that course. Cut off from SLS funds, many bad schools are closing. As painful as this may appear to be for those students who are affected, this type of shake out will ultimately benefit the program and students as a whole. It may narrow the choice for some students, but only to institutions of higher quality with a better record of delivering the education and training they promise.

There are some so-called corrective steps which I recommend be avoided. There is no room to reduce special allowance payments and further narrow the margin of incentive for lenders to continue to participate in the program. There is no excuse for imposing even greater loan origination fees or guarantee fees on students. We need less emphasis on increasing the mechanical approach to do due diligence and more emphasis placed on performance. Nor can we insist that guarantors and lenders more carefully screen out ineffective schools with high default rates and at the same time continue to insist that guarantors also serve as a lender of last resort for schools so poor in quality that no participating lender will make such loans.

Circumstances surrounding the loan programs have changed so dramatically that a repeat of the PITCO experience would be highly unlikely, if not impossible. Market corrections, measures by Congress, and other factors have produced a higher set of expectations for the future. However, it is essential that the existing checks and balances of the educational loan program be maintained, if not strengthened. We must not allow a repeat of the lender/school/secondary market/servicer loop which wrecked so much havoc in the program.

I believe there are several other vital lessons which can be drawn from the loan program's experiences, both the good and the bad of the past several years. It is clear that genuine educational opportunity requires access to quality education and training. The student loan program provides nearly half of all financial funds and does so in a cost-effective manner. Although significant reforms remain to be carried out, the basic structure of the educational loan program is sound and should be preserved. Progress can be achieved with the continued investment of resources and a strong commitment by all parties.

I know that the California Student Commission and many other dedicated program participants will continue to work to make the guaranteed student loan program a realistic means by which students and their families can fulfill their educational dreams. This concludes my written testimony and I am happy to answer any questions which the committee may have.

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CALIFORNIA STUDENT AID COMMISSION

FITCO Loan Activity Report
1980-89
(NET)

PY	NO. OF LOANS STAFFORD (GSL)	NO. OF LOANS SLS/PLUS	TOTAL $
1979-80	216	-0-	$ 532,600
1980-81	3,048	-0-	5,771,130
1981-82	2,353	-0-	4,002,798
1982-83	3,929	-0-	10,037,362
1983-84	9,059	-0-	23,404,731
1984-85	30,692	5,290	92,046,495
1985-86	35,785	6,803	109,303,188
1986-87	36,517	17,397	148,415,180
1987-88	21,664	15,765	104,775,230
1988-89	4,660	2,609	21,137,310
TOTAL	147,923	47,864	$519,426,024

CALIFORNIA STUDENT AID COMMISSION

FITCO Loan Activity Report
1988-89

BORROWING BY SCHOOL TYPE BY LOAN PROGRAM

SCHOOL TYPE	NO. OF LOANS STAFFORD (GSL)	NO. OF LOANS SLS/PLUS	TOTAL $
Out of State School	5,428	1,036	$ 17,371,760
Community College	8,369	227	17,385,396
University of California	4,178	1,047	13,607,868
California State University	9,055	717	22,974,756
Private Two-Year Nonprofit	2,350	2,565	12,745,513
Private Four-Year and Private Graduate	9,800	12,908	78,819,291
Vocational for Profit	108,576	29,233	355,203,223
Hospital Educational	102	76	827,220
Out of Country	66	58	502,621
TOTAL	147,924	47,867	$519,437,648

FACT SUMMARY
AND
CHRONOLOGY OF EVENTS

NOTICE OF INTENT TO TERMINATE LENDER FROM THE GUARANTEED STUDENT LOAN PROGRAM

CALIFORNIA STUDENT AID COMMISSION

Updated for U. S. General Accounting Office
September 25, 1990

FACT SUMMARY

Lender:	First Independent Trust Company 5325 Engle Road Carmichael, CA 95608
Directors:	Dono Evangelista, President and Chairman O. Glen Bigelow, Executive Vice President Jon Smock
Number of Shareholders:	1
Number of Employees:	50
Parent Holding Company:	Lawyers Financial Corporation
Opened:	August 22, 1975
Entered Student Loan Program:	April 9, 1980
Business Activities:	With a combined value of assets of some $67 million, served as trustee of various retirement plans and other fiduciary accounts (pension plans, estates, trust rate accounts, etc.); not licensed to conduct commercial banking; accounts not insured by Federal Deposit Insurance Corporation (FDIC); not a member of the Federal Reserve system; an eligible lender in the federal Guaranteed Student Loan Program.

Total Amount of Student Loans:	Some $1.5 billion nationally; includes over $519 million for some 200,000 borrowers under the California Student Aid Commission's guarantee.
Regulatory Actions Taken:	Notice of Intent to Terminate Participation in the California Educational Loan Programs issued to First Independent Trust (FITCO) on April 21, 1989 by the California Student Aid Commission. Liquidation of FITCO assets initiated by the California State Banking Department on May 19, 1989.

CHRONOLOGY OF EVENTS

FITCO enters financial trust business:	August 22, 1975
Establishes eligibility to participate in federal guaranteed student loan program; lends primarily to for-profit vocational school students; quickly turns loans over to secondary market:	April 9, 1980
Establishes eligibility to participate in federal supplemental student loan program:	July 1, 1982
California Student Aid Commission lender compliance review conducted:	June 27-29, 1984
California Student Aid Commission lender compliance review conducted; FITCO cited for failure to make timely refunds owed to students; a follow-up review was recommended:	March 3-7, 1986

California Student Aid Commission compliance review conducted; FITCO cited for failure to pay origination fees owed to USDE; cited for failure to make timely refunds owed students; lender informed follow-up site visit would be scheduled:	November 19, 1987 - January 21, 1988
Meeting held with FITCO top management, representatives of USDE Region IX, and the Commission; lender agrees to file appropriate forms and pay origination fees owed USDE for 1987 within two weeks; Lenders Request for Interest and Special Allowance (Form 799) were to be filed within 90 days of the end of the quarter; future quarterly payments were to be made by lender within 30 days of USDE notification:	January 14, 1988
FITCO payment of 1987 loan origination fees owed USDE ($13,339,471):	April 11, 1988
USDE issues report on review of servicing of loans by United Education and Software (UES) for loans held by the Bank of America as trustee for the California Student Loan Finance Corporation*; some $600 million in student loans compromised by faulty servicing:	August 25, 1988
March 31, 1988 Form 799 filed 138 days late:	November 16, 1988
Lender's June 30, 1988 Form 799 received 89 days late:	December 29, 1988
FITCO's September 30, 1988 Form 799 due but not filed:	December 31, 1988

*Most loans originated by FITCO were sold upon disbursement to California Student Loan Finance Corporation.

California Student Aid Commission compliance review/follow-up site visit conducted; cited for providing computers to schools as an incentive to process FITCO loans; cited for continued failure to make timely refunds; cited for failure to pay origination fees; payment overdue of 1988 (does not include estimated 4th quarter) loan origination fees owed USDE ($5,580,683):	February 27-March 24, 1989
Notice of Intent to Terminate FITCO from federal guaranteed student loan program issued by California Student Aid Commission:	April 21, 1989
Liquidation of Lender's assets initiated by the California State Banking Department:	May 19, 1989

1990-91
L, S, & T ACTIONS

eport Issue Date 9/14/90 - *(latest revisions italicized)*

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
an Diego College of Medical & Dental areers 952 El Cajon Boulevard an Diego, CA 92115	Compliance Review conducted 1/30-31 and 2/1/90	Failure to assess ATB, no documentation of eligibility of non-citizens, failure to perform required verification, improper retention of students loan proceeds, failure to make timely and proper refunds, and failure to provide required consumer information.	At least $43,781 plus excess federal subsidies.	Emergency Action not imposed.	8/1/90	8/21/90	Notice of Intent to Terminate and to Impose Civil Penalties rescinded 8/17/90 pending full review of response to audit report.
niversidad Autonoma de Guadalajara 201 Apartado Postal uadalajara, Jalisco, Mexico *nited States office address:* *029 IH-10 West, Suite 265* *an Antonio, Texas 78230-1354*	Compliance Review conducted 5/3-4/89.	Making ineligible loans - in excess of annual limits, to non-citizens, based on improper student-budgets.	In excess of $275,000	Emergency Action not imposed.	*9/13/90*	*10/3/90*	*School re-served since certified mail does not go to Mexico. Termination effective 10/3/90 unless request for hearing received by 9/28/90*

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1989-90
L, S, & T ACTIONS

port Issue Date 9/14/90 (no changes since last report)

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F Notification Date	 Effective Date	Status/Comments
ited Education & Software, Inc., dba ational Technical School 000 S. Figueroa Street, and artin Luther King Blvd. s Angeles, CA 90037	OIG Audits conducted 4/89 -6/89 for the period 6/87 -6/89	Certified loan applications for ineligible program and students; failure to make proportionate refunds; used unfair refund policy; misrepresented financial charges, improperly administered ATB testing; ineffective academic progress policies used and evidenced severely impaired administrative capability.	$21.9 million ineligible loans $1.7 million unpaid refunds	Effective 10/18/89	10/13/89	(T) 11/2/89	School is placed in "suspense" on 10/18/89. Posted $250,000 bond. School's code restored to "active" status on 10/24/89. Hearing on "Preliminary Injunction" 11/8/89. UES filed for Chapter 11 Bankruptcy on 12/4/89. UES says it must sell or close 12 of its 33 schools.
merican Video Repair Institute, Inc., dba merican Video Repair Institute 11 South Brand Boulevard n Fernando, CA 91340	Compliance initial review 5/2-3/89	Ineligible loans; failed to meet standards of administrative capability and factors of financial responsibility.	$63,550 in ineligible loans $30,921 in unpaid refunds from audit sample	Effective 7/14/89	7/13/89	(T) 8/1/89	School failed to request hearing or indicate in writing the reason not to terminate. Termination effective 8/1/89. National disqualification sought from USDE on 8/2/89.
y Business Colleges, Inc., dba ccupation Technical Institute 180 Pacific Avenue ng Beach, CA 90806	Compliance reviews conducted 6/27-28/89 and 11/7-9/89	Ineligible loans, ineligible programs, improper administration of ATB assessment, failure to obtain financial aid transcripts, improper retention of loan proceeds, failure to make refunds properly.	$70,261 in ineligible loans $4,282 unpaid refunds - both from audit sample	Effective 3/23/90	3/23/90	(T) 4/12/90	Consent Agreement finalized 7/6/90; school to pay unpaid refund liability of $74,543.31 and withdraw from participation in Part B, HEA, loan programs.
ta Technical Schools, Inc., dba ta Technical Schools 495 Paramount Boulevard ng Beach, CA 90805	Received final audit report(s) from Compliance. CA Attorney General conducted investigation 12/89 - 3/90 and filed civil complaint 3/21/90.	Ineligible loans, ineligible programs, enrolled students in ineligible school, used unqualified instructors, substantial misrepresentation of the nature of its educational program and of its financial charges.	CA Attorney General prays for $1 million civil penalty from each of 53 defendants and restitution for each student enrolled in ineligible programs.	Will not be used.	7/10/90	(T) 7/31/90	Termination documents served 7/10/90, effective 7/31/90 unless, by 7/27/90, hearing is requested. Owner requested hearing; dated 7-27-90, termination stayed pending hearing.
den State Institute, Inc., dba ecan College 330 Sherman Way seda, CA 91335, and 00 Wilshire Boulevard Angeles, CA 90010	Awaiting final audit report from Compliance, initial audit conducted 1/2-4/90	Improper certification of SLS loans, substantial misrepresentation of school's financial charges, failure to correctly determine students' dependency status, failure to obtain financial aid transcripts, improperly granted leaves of absence.	To be quantified by Compliance and verified by the CELP Official	Filed after school's 30-day response period has elapsed.	Filed after school's 30-day response period has elapsed.		1st draft, based on draft audit report completed - may be modified if final report differs significantly from draft report. School closed on 5/3/90.

1989-90
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
AB Radio, Television, Inc., dba os Angeles Broadcasters 717 North Highland Avenue, 2nd Floor os Angeles, CA 90028	Initial Compliance audit conducted 1/2-4/90	Certified students' eligibility for attendance in ineligible program, improper ATB assessment, failed to make required refunds.	At least $225,000 in unpaid refunds	Case on verge of review by General Counsel for filing, when CELP Official learned of school's closing and Bankruptcy, and loss of accreditation.	Case on verge of review by General Counsel for filing, when CELP Official learned of school's closing and Bankruptcy, and loss of accreditation.		School's owner filed Chapter 7, Bankruptcy 12/4/89. Accreditation (NATTS) withdrawn 2/90.
he Word Processing & Computer School 90 West Cerritos Avenue naheim, CA 92805	Initial Compliance audit conducted 4/6-8/88 School non-responsive to report issued 6/2/89	Non-response to outstanding issues, per Compliance letter of 10/6/89 regarding required student-consumer information, school to provide students and unpaid refunds, AGI/EFC issues and factors of financial responsibility.	$3,702 in unpaid refunds plus $4,000 in school federal subsidies.	In process of serving documents to Suspend to be followed by Termination if continuing non-response when information received (1/31/90) school being sold.	In process of serving documents to Suspend to be followed by Termination if continuing non-response when information received (1/31/90) school being sold.		School placed in "S" status because of change in ownership resulting in change in control on 1/31/90. Sale finalized effective 2/7/90 and, three weeks later, new owner closed the school. Closure confirmed 3/21/90 and audit closed 4/5/90.
alone's Colleges of Beauty 85 Fulton Mall resno, CA 93721	Compliance reviews conducted 10/26-28/83, 5/2-4/88, 2/17-18/88, and 6/20-22/89	Failure to make refunds, impaired factors of financial responsibility and administrative capability, certification of ineligible loans, improper ATB assessment, excessive charges to students, inadequate use of need analysis, certifying loans in excess of annual aggregate limits, and failure to provide required student-consumer information.	At least $30,844 plus repayment of associated federal subsidies.	Will not be used in this case.	5/11/90	(T) 5/31/90	Failed to respond to Notice of Intent to Terminate. ID inactivated on the system effective 6/1/90. On 6/8/90 received letter dated 5/30/90 from lawyer stating Chapter 11, Bankruptcy was filed. This precluded the college from termination. Letter was sent 6/22/90 withdrawing termination. School is again eligible.
ravel and Trade Career Institute 335 Atlantic Avenue ng Beach, CA 90807, and 2451 Brookhurst Boulevard arden Grove, CA 92840	Compliance reviews conducted 10/31-11/2/89, and 1/16-18/90	Maintaining "two sets of student records." Failed to establish financial need, ability to benefit, certified loans for students with prior defaults. Failed to determine correct dependency status, granted improper leaves of absence, and failed to make proper and timely refunds.	At least $70,895 plus repayment of associated school subsidies.	Will not be used.	6/28/90	7/30/90	With approval of Greg, Consent Agreement modified to provide for 6 monthly installments on liability versus original 3 monthly installments.
A Institute of Dental Technology 165 Atlantic Avenue ng Beach, CA 90807							Now exclusively a fraud investigation. Arrest warrant issued for school's owner.

1988-89
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
nited Technology College for the Handicapped, Inc., dba National Technical College 301 Victory Blvd. . Hollywood, CA 91606 605, Spring Street os Angeles, CA 90014	Initial review conducted 6/20-21/89	n/a	Restitution for 2106 students X $3000 = $6,318,000 or $6.3 Million	Effective 6/24/89	6/24/89 (T)	8/15/89	Action commenced based upon information (depositions and declarations) developed by CA Attorney General resulting in filing of 6/14/89 "Complaint for Injunction, Civil Penalties and Other Equitable Relief." Case No. C727870. Requested administrative hearing being scheduled for May/June 1990.
Independent Trust Co.	Compliance audits conducted 1/88 and 2/27 - 3/24/89	Failure, through quarter ended, 6/30/88, to remit origination fees owed CSAC. Failure for customer billing and payment at fair market value for computers and software placed in schools as inducement to obtain students loans; make timely refunds to borrowers' accounts; make any origination fee adjustments; timely manifest loan transactions thereby insurance premiums due the Commission to remain in guaranteed but non-disbursed status.	Major issues - failure through quarter ended 6/30/88, to remit some $4.5 million in origination fees owed CSAC. Failure to make timely refunds ($1.35 million and $884 thousand from 8/88) to borrowers' accounts; make any .5% (10/87-12/87) origination fee adjustments causing some 13,000 loans worth $38.5 million and representing some $460,000 in insurance premiums due the Commission to remain in guaranteed but non-disbursed status.	Emergency Action not taken	4/21/89 (T)	9/12/89	As of 9/12/89 awaiting finalization of hearing dates. Institution "seized" by Superintendent of State Banking Department on 9/15/89 - Liquidation of the company to be forthcoming, all assets frozen.

1988-89
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
ABC Colleges, Inc., dba ABC Colleges, 2213 Kern Street resno, CA 93721	Compliance review conducted 10/24-28/88	Failure to: establish Ability to Benefit; inaccurate applications and incomplete when certified; improper need analysis procedures; maintain proper loan check transaction records; inadequate SSCR processing; and inadequate provision of consumer information.	$91,480 potential; since need analysis not used since inception (10/17/86) through 12/88. $881,000 & interest & special allowance in both cases.	Effective 2/24/89	2/24/89 (T)	3/17/89	Entered into Consent Agreement 4/3/89 - 3/31/90. 1) $10,000 civil penalty payable by 6/5/89, in lieu of termination; 2) respond to remaining issues in audit report by 6/5/89; 3) conduct (and pay if liability found) refund portfolio analysis by 6/5/89; 4) develop default reduction and retention and placement enhancement plan and report on progress on 9/30/89 and 3/30/90; 5) good faith effort to resolve student complaints in 30 days and enter documentation on same in students' files; and 6) put internal processing controls to preclude CSAC commencing action to terminate due to violation of Consent Agreement. Authorization to again obtain CELP guarantees effected p.m. of 4/7/89.
merican Micromax Systems, Inc. AMS College 1015-A Bloomfield Avenue anta Fe Springs, CA 90670	Compliance test review 9/83	Found via discussion with HEAF, had certified loans for 27 CA GSLs for attendance at Computer Training School (an ineligible school) using AMS ID#.	Ineligible loans total $52,400	Effective 7/21/88.	7/21/88 (T)	8/10/88	ID # inactivated 7/21/88. Consent Agreement executed 9/1/89, see AMS L,S & T file for its terms/conditions.

1987-88
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
Fashion Careers International, dba [illegible] Academy 973 Market Street San Francisco, CA 94103	Compliance review conducted 12/29-30/87.	Failure to: make proper Pell grant eligibility determinations; maintain complete, accurate GSL applications; improper certification of independent student status ([illegible]); establish correct student budgets; make proper refunds when due; inadequate provision of consumer information; and process SSCR of 9/87.	Not quantified until refund calculation listing prepared and remitted to CSAC, per direction of Compliance-Audits Supervisor.	Effective 5/12/88	(T) 5/12/88	6/20/88	Emergency Action based on refund problems and failure to respond to request for specific refund [illegible] calculation and listing. Owner failed to: respond to demand for payment of $160,799 in unpaid refunds made on 3/31/88 as evidenced by the "Enrollment and Refund Analysis" dated 3/10/88; request a hearing or a prehearing conference and provide written materials to show termination should not take place. Owner notified of termination by letter on 7/1/88. On same day USDE requested to consider "national disqualification." USDE followed up by letter on 7/20/88.
M & C Beauty Colleges, Inc., dba Continental BC, Sacramento	Compliance review conducted 7/87	Failure to make refunds, retention of unearned student funds, possibly ineligible loans.	$30,000 unpaid refunds/credit balances $15,000 ineligible loans	n/a	n/a		Consent Agreement negotiated 8/13/87; school in compliance with agreement as of 12/04/87. Lost NACCAS accreditation at 2/88 NACCAS meeting. CSAC inactivated ID # for further guarantees on 3/23/88.
[illegible] Colleges of Beauty all located in Fresno, CA 3241 North [illegible] Street 4060 E. Kings Canyon Road 3125 West Shaw Avenue 965 Fulton Mall	Compliance reviews conducted 10/83, 8/84, and 2/85.	Failure to make timely and proper refunds, provision of inaccurate monthly withdrawal and refund information, and failure to implement program of exit counseling for students.	$15,000 in refund checks returned to CSLP lender (1/85 and 2/85) because of non-sufficient funds. Subsequently, "covered" via cashier's checks.	Effective 3/15/85	(T) 4/12/85	6/3/85	Consent Agreement executed 6/28/85, to continue through 6/30/89.
[illegible], Inc., dba Cabrillo School of Nursing	Compliance review conducted 5/86	Failure to: make refunds; maintain proper, current, complete student academic and financial records.	$320,000 in unpaid refunds	n/a	(T) not available in the file	8/11/87	Consent Agreement executed 12/8/86; violated 4/27/87 by failure to provide response to unresolved issues. Schools closed 10/10/87 and lost accreditation and eligibility to participate in Title IV programs. Filed 11 USC Chapter 7 Bankruptcy on 12/1/87. First meeting of creditors scheduled for 12/30/87. CSAC inactivated ID# for further guarantees effective 10/10/87.

1987-88
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Type of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F: Notification Date	Notice of Intent to L, S, T or F: Effective Date	Status/Comments
M & C Beauty Colleges, Inc., dba Broadway BC, LA Continental BC, Van Nuys Continental BC, Pico Rivera Continental BC, Hawthorne Continental BC, Rancho Cordova	Compliance review conducted 6/87	Failure to make refunds, retention of unearned student funds, potentially ineligible loans.	$150,000 unpaid refunds/credit balances $41,000 ineligible loans	Effective 8/24/87	10/2/87 (F)	10/27/87	Attempting to negotiate Consent Agreement at $35,000 per month 1/88 - 5/88. [illegible] CSAC withdrew EA and Notice of Intent to Terminate without prejudice on [illegible]. Schools transferred by USDE [illegible] during 1st week of 5/88; CSAC transferred schools ID's for further guarantees on [illegible].
University of Cosmetology	Compliance reviews conducted 6/13-25/84 and 3/24-26/87	Failure to make refunds.	$83,000	Effective 9/2/87	n/a		Reached Consent Agreement 9/18/87; [illegible] letter dated 9/22/87 acknowledging payment of refunds totaling + $85,000. Emergency Action lifted and school remains in compliance with Consent Agreement.
Cal West College	Compliance reviews conducted 8/85 and 1/87	Failure to: make refunds timely [illegible] establish ability to benefit [illegible] improper granting of leaves of absence [illegible] make available required consumer information; and improper [illegible] and attach enforcement provisions.	$40,000 by sampling; but since records are a "shambles", could be several hundred thousand dollars. [illegible] at time of termination.	Effective 7/22/87	not available in the file (T)	8/13/87	Notice of Intent to Submit Written Materials to CSAC dated 8/13/87, received 9/1/87. CSAC reviewed written materials and responded 9/16/87; not found mitigating. School terminated 9/16/87. CSAC transferred ID for further guarantees, same date. USDE Notice of Review of CSAC's termination sent to school 11/20/87; USDE Notice of Disqualification from GSL, SLS, and PLUS to Cal West 2/5/88, signed by Secretary Wm. Bennett and effective on the date of letter.
Future Technical Institute, Inc., dba Future Technical Institute	Compliance review conducted 7/7-10/87	Violations range from failure to establish ability to benefit to failure to use most analysis methodology through failure to document citizenship status.	$15,000 in unpaid refunds, [illegible] records on Record, if ineligible loans not "cured", whole portfolio of $900-800,000 could be at risk.	Effective 7/28/87	not available in the file (T)	8/8/87	No hearing requested or written materials presented. School closed by owner - terminated 8/8/87 by transferring ID for further CSAC guarantees.

1986-87
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
North County College	Compliance review conducted 1/87	Placed on one-year monitoring due to concerns over attrition/default rates, timeliness of refunds, administration of CGSLP, student complaints, and conduct of fiduciary responsibility.	not quantified	Effective 6/25/87	n/a		On 3/24/87, IRS seizes school's assets. CSAC administratively suspends processing new GSL's on 3/25/87. On 5/13/87, AICS accreditation expires and school does not renew and has no plans to do so. On 6/11/87, CSAC notifies school that since loss of accreditation, school no longer eligible to participate in Title IV programs, (i.e., ID# inactivated for further guarantees)

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1985-86
L, S, & T ACTIONS

Corporate/School Name & Address	Basis for Action	Types of Violations	Potential Liability	Notice of Emergency Action	Notice of Intent to L, S, T or F		Status/Comments
					Notification Date	Effective Date	
Super Shapes College of Cosmetology	Compliance reviews conducted 10/85 and 2/86	Failure to: make refunds; assess ability to benefit; accurately record and retain check transaction [illegible] of commissioned salespersons to process GSL's accurately and timely process SSCRs; and maintain proper complete, current student academic and financial records.	$200,000	Effective 6/25/86	(?) not available in the file	7/17/86	USDE withdrew school's eligibility to participate in GSLP, therefore, CSAC withdrew termination action without prejudice, and cancelled the administrative hearing on 8/26/86, and inactivated ID# for further guarantees.
Sierra College of Business	Compliance review conducted 5/19-23/86 HEAF review conducted 5/30-28/86, our action, in part, based on findings of HEAF.	Failure to: make refunds; establish ability to benefit; maintain records; accurately report ADA; maintain records on check transaction dates; document continued half-time enrollment; and verify satisfactory academic progress.	$100-150,000 by sample, but inaccuracy of records suggests liability could be greater.	Effective 5/16/86	(?) not available in the file	7/7/86	School lost AICS accreditation effective 7/14/86, therefore, lost eligibility to participate in the Title IV programs. On 9/17/86 CSAC withdrew termination action (without prejudice) on the basis of lost accreditation. ID# inactivated for further guarantees.
Story, Inc., dba Academy of Stenographic Arts	Compliance review conducted 7/86	Failure to: make refunds; establish ability to benefit; accurately certify applications; accurately report ADA; document satisfactory academic progress; and maintain proper current, complete student academic and financial records.	$170,000 in unpaid refunds	Effective 1/20/86	(?) not available in the file	2/13/86	Parties (CSAC, via Attorney General, and Story, Inc.) have failed as of 12/23/87, to negotiate an acceptable Consent Agreement. Emergency Action remains in place. ID# inactivated for further guarantees by CSAC. No new CGSLP loans being made since 1/20/86; [illegible] school has obtained new loan guarantees from HEAF since that date.

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Hearing Follow-up Questions

DR. SAMUEL M. KIPP III
Executive Director
California Student Aid Commission

Q. Please explain the problems surrounding the 1988 COHORT default rate as published by the Department of Education. How did these incorrect data adversely affect the program in California?

After reviewing the Department's 1988 cohort default listings, the California Student Aid Commission was surprised to see a sharp drop in the number of high-default-rate schools and an abrupt decline in the published default rates of certain schools. Probing further, we discovered that nearly $400 million in loans formerly serviced by United Education and Software (UES) inadvertently had been treated as if all were in repayment. In fact, these loans made to students attending schools throughout the country and guaranteed by at least four guarantors were in a suspended status at the Costa Mesa Servicing Center (CMSC) during a moratorium to determine which might be eligible for claim. Their inclusion in the formula for determining the 1988 cohort default rates had the unintended effect of artificially lowering the real cohort rates of hundreds of previously identified high-default-rate schools in California and throughout the country.

The 1989 Budget Reconciliation Act denied eligibility for the Supplemental Loan Program (SLS) to schools with a cohort default rate of 30 percent or higher. Many schools that were ineligible for SLS loans by virtue of high 1987 cohort default rates were assigned 1988 rates by the Department of Education that counted a significant number of loans as being in repaymet but not in default although they were more than 180 days delinquent. The Student Aid Commission immediately notified the Department, HEAF and USAF of its findings and urged a prompt correction of those published rates to preserve the intent of Congress to limit eligibility for SLS loans only to those institutions with default rates below thirty percent. Everyone agreed that there were serious problems with the accuracy of the original 1988 cohort rates, but the Department informed us that they would not be able to correct their published rates without additional authority from Congress to do so. The Student Aid Commission had alerted Congressional staff of the serious problem on May 10 and now turned to Terry Hartle and several other House and Senate staff for assistance. The necessary language to correct the 1988 cohort default problem was included in the Student Right to Know Bill that passed both houses of Congress and has now been signed by the President.

In the meantime, the Commission believing it was following the wishes of Congress as expressed in the 1989 Budget Reconciliation Act continued to rely on the 1987 cohort rates rather than the seriously flawed 1988 published rates to edit for SLS eligibility for those high default rate schools with substantial numbers of loans at CMSC in suspended status rather than repayment. It is our understanding that none of the other guarantee agencies involved built the cohort rates into their system of school eligibility edits before issuing a guarantee and that they relied instead on the inaccurate 1988 rates contained in the Department's letters to these schools. We were pressured by several of these schools to resume SLS guarantees for their students, but we continued to rely on the only accurate cohort data we had and awaited written direction from the Department on how to proceed until correct 1988 cohort rates could be calculated. The Commission has indicated to all parties concerned that it stands ready to comply with any written directives from the Department on this matter. To date, we have never received any written direction from the Department either clarifying what process to follow or requesting that we change our existing procedures.

The recent passage of the 1990 Budget Reconciliation Act by Congress makes it imperative that the flawed 1988 cohort default rates of numerous institutions get corrected promptly, but also that the 1989 and all subsequent cohort rates be computed accurately. The three year cohort default rate provisions affecting Stafford eligibility as well as the ongoing *SLS* eligibility requirements will not achieve the savings demanded by Congress if the published rates contain inaccuracies that understate the actual default experience of schools. Furthermore, if the exception appeal process outlined in the Act results in the Secretary restoring eligibility for high default rate institutions that have consistently served students poorly, students will not be protected adequately, the required savings will evaporate and public confidence in the loan program will remain at a dangerously low ebb.

Q. **Do you think the COHORT rate should show the data from schools which no longer participate in the student loan program and for foreign schools so that the Department and guarantee agencies are aware of their default rates?**

Including such schools serves as a reminder of what their participation in the program continues to cost the American taxpayer. On the other hand, the inclusion of closed schools overstates the number of high default rate schools that are still operating and continuing to victimize students. For example, out of the 107 high default rate proprietary schools in California in the 1987 cohort there were eleven that had been terminated by the Student Aid Commission. At the same time, I have serious reservations about granting any except the most reputable and well recognized foreign colleges and universities eligibility to participate in the loan programs. On balance, I think that the cohort default rate should be computed for all schools that had a sufficient number of borrowers entering repayment in that particular cohort whether the school is closed or open, foreign or domestic.

Q. **Is there a better way to figure and publish default data?**

The Student Aid Commission has always taken the position that the cumulative gross default rate is the best overall measure of the performance of the students at a particular institution and a reflection of how well or poorly the institution has equipped them to participate productively in the American economy. True, the cumulative gross rate changes only slowly over time, but the cohort default rate computation has four weaknesses even when all the data used are accurate.

- Because the cohort rate includes only defaults that occur within the cohort year and the following federal fiscal year, it provides an incomplete measure of the defaults that actually occur among students who entered repayment in any particular cohort;

- Because many proprietary institutions have only a few students entering repayment in any one year, the cohort rate has all the statistical problems of any measure based on small numbers. The three year averaging provision will not help resolve the problem of schools that currently do not have an official cohort rate and this fact could prove to be a serious problem in enforcing the "most current three years' cohort rate" provision for Stafford eligibility;

- o The cohort default rate is based on the number of borrowers who enter repayment in a particular year and who subsequently default in that or the following fiscal year, not on the number of loans or the value of loans in repayment and default. Because SLS borrowers are considered in "repayment" immediately after disbursement while Stafford borrowers enter repayment six months after completing their program or leaving school, a borrower taking out both a Stafford and an SLS loan in the same school year would in almost all instances be included in two separate cohorts; and

- o Because SLS loans enter "repayment" immediately after disbursement but are often deferred until after the borrower leaves school, it becomes difficult if not impossible for a substantial proportion of all SLS borrowers in any particular cohort to actually complete the delinquency-default cycle in time for their defaults to count at all in the computation of cohort rates. Consequently, use of the cohort procedure to calculate default rates for SLS borrowers seriously understates the actual default exposure. To the extent that SLS loans now make up an increasing proportion of all loans in a cohort, the true default levels of many schools are understated significantly.

For these and related reasons, the Commission continues to believe that the cumulative gross default rate would be a better, more accurate measure of institutional effectiveness than the three years of cohort default rates adopted in the 1990 Budget Reconciliation Act for use in determining institutional eligibility for the Stafford Loan program. It would probably also serve as a better overall measure for determining institutional eligibility for all loan programs because in our experience the default performance of students at a particular school rarely fluctuates markedly from year to year.

Q. Does CSAC have a write-off policy for students who were victims of fraud by schools or lenders? Do you have a write-off policy for student borrowers whose schools are closed due to other action, such as bankruptcy or loss of state license?

When the Commission determines that a student has received an ineligible loan, it attempts to recover the funds by collecting from the school that improperly certified the loan not from the student. In instances where the Commission discovers that fraud has been committed and an innocent party has had their social security number used wrongfully by others to secure a loan, the Commission will end its attempts to collect against the innocent party and pursue more appropriate measures against the perpetrator of the fraud. The Commission submitted to the Department a draft proposal for a write-off policy to deal will small balance accounts and certain cases involving closed schools where the student was unable to receive a teachout or recover monies owed from the state tuition-recovery fund. To date, the Department has not responded. Thus, we still do not have a write-off policy covering student borrowers whose schools are closed.

Q. Is it your understanding that FITCO was determined an eligible lender by the Department of Education in the FISL and/or the NDSL programs prior to CSAC permitting FITCO to participate in the GSL programs? Was FITCO's eligibility for participation ever questioned by CSAC?

I have no direct knowledge of these events, but it is my understanding that the initial determination of FITCO's eligibility to participate in the student loan program was made by the Department of Education. A search of our files reveals the following information about the initial determination of FITCO eligibility to participate in the California Guaranteed Student Loan program:

- An April 11, 1980 letter from the Commission to Larry Oxendine of the Department indicates that the Commission had received agreements to participate from FITCO but was unable to verify the institution's status as an eligible lender on the OE List of Eligible Lenders. The letter questioned FITCO's eligibility and asked the Department to verify FITCO's actual status.
- A May 30, 1980 letter from the Commission to FITCO indicating that the Department had assigned Vendor Number 827306 to FITCO.
- A copy of an Agreement for Participation in the Guaranteed Student Loan Program between the Department and FITCO signed by Demo Evangelista of FITCO on December 16, 1980 and by Richard Hastings of the Department on February 4, 1981; and
- A February 23, 1981 letter from the Commission to FITCO indicating that the Commission had received the Agreement for Participation from the Department and that the Commission had informed its processing center that FITCO could now process applications.

FITCO was never an eligible NDSL lender because only qualifying postsecondary institutions were able to make loans to their students in the NDSL program.

Q. **Prior to 1986, the law clearly prohibited a lender from making student loans as its primary consumer credit function. Were you aware that FITCO had violated that statutory provision? If so, did you bring the matter to the attention of the Department of Education?**

According to the Commission's records, Commission staff made a number of attempts to determine whether FITCO had violated this statutory requirement but was unable to clearly establish the necessary evidence because of uncertainty about some of the legal dimensions of the trustee relationships and the inability to secure the necessary information on the full range of FITCO consumer credit business. Staff phone discussions about these questions with the Department were inconclusive.

Staff questioned this regulation when assigned to write the 1984 review report on FITCO. Further, as part of the 1986 review, staff called the State Banking Department [illegible] inquired whether they had jurisdiction over FITCO and if so, how could the Commission determine FITCO's consumer credit dollar volume. The State Banking employee informed staff that the student loans issued by FITCO were actually held by the trustors and, therefore, were not considered as being held by FITCO. While further efforts were made to determine the implication of holding loans in trust, the 1986 report did not include any comment or citing regarding the size of FITCO's loan portfolio. Apparently, the staff member who wrote the report was satisfied that no citing existed.

The Commission shared a copy of its 1986 compliance review of FITCO with the State Banking

Department. A formal request was made by Commission auditors on February 22, 1987, asking the State Banking Department for a copy of their most recent examiner's report on FITCO, but the Commission never received a copy of their report.

The Commission reviewers were unable to determine whether FITCO was in violation of the earlier prohibition and secured no cooperation or assistance from other parties whose expertise made them better able to make such a determination. By late 1986, this prohibition was made moot. Consequently, the issue was not brought to the attention of the Department by the Commission.

Q. Evidently, in 1985, the California State Banking Department questioned whether FITCO was an eligible lender under the law, given that provision, as well as the fact that the statute did not include "trust companies" within the term "eligible lender." According to the California State Banking Department, CSAC "took the position that FITCO was an eligible lender" -- could you explain why?

I became the Commission's Executive Director in January 1986 and have little direct knowledge as to why the Commission took the position it did. I assume it believed that FITCO was an eligible lender because the Department of Education deemed them to be eligible. Based on that Departmental determination, the Commission signed a lender's agreement with FITCO. Attempts by Commission staff to clarify the questions raised by State Banking in 1986 through phone conversations with the Department proved fruitless. Within months, these issues were made moot.

Q. Did CSAC ever discuss the question of whether FITCO was an eligible lender with the Department of Education? If so, what was the Department's position.

As noted earlier, the Commission discussed the question of FITCO eligibility with the Department on several occasions. To my knowledge, it was always the Department's position that FITCO was an eligible lender.

Q. To what extent did CSAC or HEAF as guarantee agencies for FITCO, exchange information with the California State Banking Department, which was the State regulator of FITCO? Who did you exchange pertinent information with? Who did you notify when you discovered problems at FITCO?

According the Commission records, there were a number of contacts between the Commission and the State Banking Department. Commission auditors contacted State Banking with specific questions about FITCO on at least three occasions.

- o The earliest contact was an inquiry about FITCO's loan portfolio and how to determine if its consumer loan portfolio included more than 50 percent student loans. As noted earlier, no satisfactory answer was ever received.
- o The second contact was in early 1988 following the Commission's November 1987 - January 1988 review of FITCO. Commission auditors had obtained copies of documents that indicated what staff felt was a misuse of borrower refund monies. Staff called to

determine if the State had any law or regulation it could use to cite FITCO for using borrower refunds for other purposes. Staff also questioned FITCO's right to invest the funds in interest bearing accounts. Commission staff was told by State Banking that there was no law or regulation that stipulated what a lender could or could not do with refund monies received. Therefore, having nothing to support its contention of a misuse of funds, the Commission did not include this finding in its report.

o Sometime after the Mercury Savings Review in March 1988 and the writing of the 1989 FITCO report, Commission staff again contacted State Banking to see if there was a law or regulation that prohibits a lender from selling a promissory note prior to the full disbursement of funds. Staff was told no, that actually it is a common practice with many lenders. Lenders offer customers line of credit notes and often sell the note prior to full disbursement of the credit limit. Once subsequent disbursements are made, the current holder purchases the additional portion. Based on this information, staff did not cite FITCO for making second disbursements when they no longer owned the note.

There were certainly other contacts between the Commission and State Banking concerning FITCO, including the Commission sharing its 1986 review with State Banking and the Commission's unsuccessful attempt in 1987 to secure a copy of the most recent State Banking reviewer's report on FITCO.

The Commission's compliance staff always provided Region IX of the Department with copies of each and every compliance review it conducted of schools or lenders. In addition, pertinent information involving problems or mutual concerns about banks or schools were shared when appropriate with other guarantors such as HEAF and other regulators such as the Office of the Inspector General and the State Attorney General.

Q. We understand that the State Banking Department, for example, did not have access to program reviews that CSAC made of FITCO. In retrospect, should they have?

The program reviews conducted by the Commission have always been considered public documents and were available to the State Banking Department and others upon request. A copy of the 1986 Commission report was orally requested and promptly provided to them. Other reviews would have also been provided if they had been requested. In retrospect, perhaps we should have sent them to State Banking routinely. It would have also been helpful if they would have cooperated by sharing copies of their reviews with the Commission when questions of lender solvency or issues involving the student loan program were raised.

Q. In your statement you say that changed circumstances have made a repeat of the FITCO experience "highly unlikely, if not impossible." What changes are you referring to?

I did not mean to suggest that there are not other lenders with insufficient capital that overextended themselves and became major players in the student loan program during the latter half of the 1980s. I also did not mean to imply that in the current environment they might not also be experiencing financial difficulties that could threaten their viability. The Bank of Horton comes immediately to mind. It is also true that the second Nebraska guarantee agency pursued growth policies that were not unlike those of HEAF and that both they and their secondary market could face severe problems in the not too distant future.

I was referring specifically to both changes in the financial markets and in the regulatory environment. The cost of credit support for student loan secondary market bond issues was raised to reflect the great risks of student lending. Tax law changes governing arbitrage earnings and the increased cost of credit support have combined to narrow the spread on bond issues and force much greater attention to portfolio composition. Servicing costs and risks have focused greater attention on the importance of quality servicing and the performance differences among third-party sevicers. Tighter restrictions on portfolio composition and secondary market purchases are now commonplace and directly affect primary lending practices as well. HEAF's financial woes and those of a few other guarantors have focused greater attention by banks, credit providers, and secondary markets on guarantor solvency. Furthermore, the financial dynamics of the program and the HEAF experience have forced guarantors who were not already doing so to pay greater attention to the performance of their lenders and schools and to the composition of their portfolios. Congressional concerns, Departmental regulations, public demands for accountability at the state and national level, and the examples provided by the more innovative participants within the loan program have created both a demand for greater quality and performance within the program and models of how to achieve positive results.

Taken together these forces make the emergence of new lenders pursuing dangerous lending practices; new servicers offering cut-rate, substandard servicing; secondary markets purchasing large volumes of loans to marginal students at high-default rate schools; and unbridled growth in guarantee volume unlikely, if not impossible, in the future. At the same time, there will no doubt be a further shake out within the student loan program of some of its current participants who succumbed uncritically to the excesses of the late 1980s.

Q. CSAC made numerous adverse findings as to FITCO, to wit:

- **On March 1986. CSAC cites FITCO for failure to make timely refunds;**
- **November 1987 to January 1988 -- CSAC cites FITCO again for failure to make timely refunds and for failure to pay origination fees;**
- **August 1988, the Department, CSAC, and HEAF cite $600 million in loans originated FITCO and held by CSLFC as compromised by faulty servicing by UES;**
- **November to December 1988 -- FITCO files late or fails to file three Form 799s;**
- **February 1989 -- CSAC again cites FITCO for, among other things, failure to make refunds and failure to pay loan origination fees.**

CSAC finally terminated FITCO in April 1989. Prior to doing so, however, and during the same time frame of all the adverse findings mentioned above, CSAC guaranteed nearly $400 million in FITCO-originated loans. Why did you continue to guarantee FITCO loans, given its history of violations? Why did it take so long to terminate FITCO?

The 1986 Commission review was the first citing of untimely refunds. Generally, no action is taken during the first occurrence of a problem. FITCO also met with the Commission's former Deputy Director for Loans regarding the issues found during the 1986 review and submitted his assurances that the refund issue had been corrected and was being handled timely.

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At the time of the November 1987 - January 1988 review Commission compliance staff were very concerned with the issue of late refunds, the magnitude of the refund problem, and FITCO's use of refund monies for other purposes. The State Banking Department response on the use of funds issue, undermined that finding, but the Commission's compliance unit recommended some type of administrative action against FITCO to the former Deputy Director for Loans. He decided to only cite FITCO for untimely refunds and order a follow-up review.

Subsequently, the Commission's organizational structure was changed so that the Compliance Unit reported directly to the Deputy Director for Administration.

The August 1988 joint review of UBS was only a review of loans serviced by UBS and held by CSLFC. The focus was upon the major servicing problems there, not on the role of FITCO or any other lender who had sold loans to CSLFC.

Prior to the November 1987 - January 1988 review, Region IX of the Department of Education was responsible for reviewing the accuracy of the Form 799 billings. The filing of the 1988 Form 799s by FITCO was not being monitored by the Commission. While it was the Commission's reviewers who uncovered the failure of FITCO to pay origination fees, Jack Keefe of Region IX was alerted by our staff and then made arrangements for FITCO to pay the outstanding origination fees. Commission staff was under the impression that the Department was monitoring FITCO's interest billings and checking to make sure origination fees were being remitted.

The Commission's February 1989 review revealed that this assumption was incorrect and that there were continuing problems at FITCO. On the basis of those findings, the Commission did take a termination action in April.

Q. **It was brought to our attention that you have actually hired trained fraud investigators on your staff -- can you comment on this unique move for a guarantee agency?**

Faced with increasing reports of fraudulent activity by students and institutions in the student loan program, the Commission added a full-time fraud investigator to its staff in about 1987, effectively doubling the size of this tiny unit. In the first year after the current Supervising Special Investigator was hired, the fraud unit made numerous arrests and recovered nearly two million dollars from persons attempting to commit fraud on the program. Based on this initial success and the units growing workload, additional investigators were hired. The Commission currently has on staff four full-time and one half-time investigator with varying backgrounds. Both the Supervising Special Investigator and two of his investigators are former policemen with extensive police experience. The other full-time investigator formerly worked for a credit card company as an investigator and has extensive experience and knowledge regarding credit card fraud and other forms of "white collar crime." Other state guarantee agencies such as Pennsylvania and Colorado also have investigators, but I am not familiar with their background and training.

Q. **It was also brought to our attention that CSAC has had a problem with unissued Social Security numbers appearing in the loan guarantee files. Please explain about this. What problems have you had with the Social Security Administration?**

decade. At private universities, annual tuition increases generally exceeded the CPI by a full two percentage points or more.

- At private vocational technical schools tuition also increased dramatically especially during the last four years of the decade.

There was a dramatic shift in the basic sources of financial support available to students who needed help financing their education.

- The financial squeeze faced by many families because salaries and wages during the decade rarely kept pace with inflation was exacerbated by sharp increases in housing costs. These pressures were also evident in the low savings rate among American families. Taken together these patterns contributed to a pronounced shift in the responsibility for helping finance college education from parents to their children.

- Major budgetary strains at both the state and national level along with a change in philosophy during the Reagan years led to a dramatic shift from grants to loans as the major source of financial aid. Within the federal loan programs this was compounded by a shift in emphasis from more to less subsidized forms of loan aid -- increasing eligibility restrictions on Stafford loans and a virtual "available for the asking" policy on SLS loans.

- Under the Higher Education Amendments of 1986 annual and aggregate student loan limits in both the Stafford and SLS programs were increased. The application process, $4,000 loan limits, and exemption from multiple-disbursement made the SLS program extremely easy and attractive. The SLS program which had been created to provide supplemental loans for independent upper-division and graduate students at high-cost private colleges became instead the favorite vehicle for exponential growth in borrowing among "nontraditional, older students" at vocational schools.

The federal government basically turned over the process of determining institutional eligibility for Title IV aid to accrediting associations that at times were little more than self-regulating private trade associations. State licensure oversight and protection for students was weak to nonexistent most places because it too relied almost entirely on accrediting bodies. Most guarantee agencies did not have sufficiently large compliance units to oversee the performance of schools and lenders. Whether out of fear of being sued or concern about losing volume, most agencies were extremely reluctant to take L, S & T actions.

- Under the circumstances, there was a tremendous growth and proliferation of private vocational technical schools participating in the student loan programs. The growth involved not only a sharp increase in the number of new "schools", but also a proliferation of branch campuses among existing schools and the growth of large proprietary chains.

- The ready availability of both Stafford and SLS funds also contributed to the proliferation of short-term under 600 clock hour programs. Even though such programs were ineligible for any form of Title IV grant aid, the new SLS program made it possible to package students with GSLs and SLSs to cover high tuition costs for short-term programs that rarely prepared even their graduates for more than a minimum wage job.

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The Commission has had a problem with unissued Social Security numbers appearing in its loan guarantee files. When the problem was first discovered, the Commission took steps to create edits in its computer system to screen for valid Social Security numbers before any guarantee was issued. Unfortunately, the Social Security Administration could not provide accurate, updated tapes of the range of valid issued numbers to use in the edit. Such ranges were assigned to each office, but actual practices varied so widely from office to office that the edits resulted in rejecting recently issued, valid Social Security numbers for young borrowers. Further discussions were held to try to resolve the problem, but Social Security officials proved uncooperative. To date, they have been unable to supply accurate updated information and informed the Commission that they would no longer attempt to do so. Until something is done to secure greater cooperation, the edits will remain inoperative and the problem of invalid Social Security numbers will continue for the Commission and all other guarantee agencies.

Q. **What considerations are given before your guarantee agency decides to give a lender identification number to a lender?**

In most instances, a prospective lender will contact the Commission to request information about the student loan programs and lender agreements. During the phone call, Lender Services staff will ask questions to attempt to determine if the institution requesting the information appears to meet the requirements of the law regarding lender eligibility. If the potential lender appears to be eligible, staff sends a copy of the Program Summary (summarizing the purpose of the program and the general policies and procedures of the program), a copy of the California State Regulations and two copies of the lender agreements (one original copy will be kept by the lender and another original copy will be kept by the Commission). In the cover letter which accompanies these documents, the Commission will request any additional items it thinks may be necessary to determine eligibility, often including financial statements, copies of a state charter or a copy of the state law which designates a nonprofit private agency to be an eligible lender. The Commission may also ask for information regarding which government regulatory agency the institution reports to

When the Commission receives signed lender agreements from a potential lender, it attempts to determine eligibility based on all the information it has assembled. Once the Commission deems an institution otherwise eligible it makes sure the lender has obtained a lender identification number from the Department of Education and completes the steps necessary to set the lender up on the Commission database.

Q. **What factors caused the immense growth and competition in the secondary markets and guarantee agencies in the mid-1980s?**

This is a difficult question to answer with any great assurance, but there are a number of factors that contributed to explosive growth during the second half of the 1980s. The following sections attempt to categorize and outline the contributing factors without attempting to rank them according to their relative impact.

The cost of securing a college education or postsecondary training increased dramatically:

- Tuition and required fee costs at traditional, four-year public and private institutions increased much more rapidly than general inflation or family incomes throughout the

- The ready availability of up to $6625 in loans per year ($2625 GSL and $4,000 SLS) also facilitated the growth of correspondence school programs through the use of slick radio and TV ads geared to mass marketing campaigns.

The economics of secondary market finance strongly encouraged the adoption of growth strategies.

- The entry of major Japanese banks into the letter of credit business made credit support both easier and less expensive to secure and made the cost of issuance and bond financing more attractive.

- Ironically the tightening of arbitrage earning rules in Reauthorization led to a tremendous flurry of new bond issues designed to beat the two year grace period before the new rules took full effect.

- The availability of several seemingly attractive low-cost (as it turned out high-risk) loan servicing firms combined with more favorable financing terms to increase the effective spread for some secondary markets.

- The nondiscrimination requirements for tax exempt bond financed secondary market purchases made it difficult for secondary markets to control adequately their portfolio composition.

- The combination of all of the above factors coupled with an inadequate understanding of the true costs of the recently introduced due diligence requirements led to a dramatic loosening of the loan purchasing policies of many secondary markets. The proportion of high delinquency, high default rate vocational technical school paper held by most secondary markets increased dramatically.

- The economics of secondary market bond financing, particularly the low or lost earnings that occur in the seventh through tenth year of most repayment paper because of the relatively high servicing cost to loan balance ratio, creates a tremendous financial incentive for secondary markets to continue to expand their new loan purchases each year to maintain overall favorable earnings. The role this plays in fostering an intensely competitive secondary market environment is difficult to overstate.

- The new more liberal purchasing policies of secondary markets were reflected quickly by primary lending practices. The ready availability of secondary market liquidity at attractive premiums reduced the risks and costs of lending to vocational technical schools and stimulated increased lending to high risk students at high risk institutions. Under these circumstances, lenders anxious to increase their market share found an abundance of customers at the margins of the program among proprietary institutions that had not been served by more established lenders.

The current structure of guarantee agency financing tends to encourage growth in new guarantee volume.

- Two of the four major sources of funds to support guarantee agency operations are directly tied to new loan guarantees. The administrative cost allowance (ACA) guarantee agencies receive from the federal government to cover some of the costs of administering the loan programs is based on new loan volume -- a payment of one percent of new loan guarantees. The guarantee or insurance fee charged by all guarantee agencies to provide essential monies for their default reserve and administrative reserve funds can be up to three percent of the face value of each new loan guaranteed. The other two sources or investment earnings on the reserve fund and the 30 percent retention permitted on collection recoveries from defaulters (the remaining 70 percent is returned to the federal government) relate more to past growth rather than new guarantee volume.

o Given the narrow margins for operating a guarantee agency and the continually increasing cost of software and hardware changes and the expense associated with shifting more of the responsibility for the administration and oversight of the program to guarantee agencies, the ability to provide quality service to students, institutions, and lenders requires that guarantee agencies achieve economies of scale and maintain a growing revenue base.

o The aggressive marketing of loan guarantees by HEAP and USAF throughout the country, not just in those states where they were the designated guarantors came at the expense of many state designated guarantors although their initial inroads were often among the more marginal proprietary institutions in these states. While such activities by national guarantors increased the direct competition for new loan volume, it also created an environment that made regulatory oversight of marginal institutions by state designated guarantors more difficult. At the same time, HEAP and USAF rarely focused on compliance reviews or enforcement.

Q. Do you believe we need over 50 guarantee agencies?

No.

TESTIMONY

before the

Permanent Subcommittee on Investigations

United States Senate

September 26, 1990

GREGORY VOELM, DIRECTOR

Student Loan Trust Task Force

Representing Financial Trust Victims of the Student Loan Program

Mr. Chairman and Members of the Subcommittee:

I am here to tell you that this problem is not about big financial institutions or government agencies. It's about individual Americans who responded with their savings when the federal government called for support of its student loan program. It is about children and retired people, it is about parents and working men and women who relied on the full faith and credit of the U.S. government to protect the funds they placed in trust to help students get an education.

Let me start by telling you about Jonathan. He is seven years old. He is my son. He put his meager little savings in FITCO because I told him it was the right thing to do. I told him he could trust the government.

Now, I don't know what to tell him. We live in California, but Jonathan has a picture in his room of the Washington skyline. In that picture, the Capitol dome glows in the moonlight like a temple of justice.

Jonathan asks me when the government is going to return the savings we put up to help students go to school. He knows that I have been working for seventeen months to get back our money and the savings of thousands of other families. I keep telling him, "I'm sure we'll have our money back soon, son," but it is hard to hold back the fear and the bitter feeling of being betrayed.

The people who have sent me here to speak for them are solid citizens, but hardly your idea of highrollers. They include small businesses and the Shiloh Baptist Church, doctors, carpenters, judges, secretaries, lawyers, and truck drivers. And there are hundreds of retired people whose life savings are being held hostage by the actions of the U.S. Department of Education.

Many of us who have been devastated by the federal student loan disaster live on the West Coast, but our members also represent most of the other states in our country as well as the District of Columbia. We are not fools, we simply believed the guarantee of the full faith and credit of the United States as it was given to us. We put our money in trust with an approved lender in the U.S. Student Loan Program: the First Independent Trust Company of Sacramento which [illegible] later found out regulators call FITCO. We saw the advertisements, we heard the radio spots [illegible] we read the papers we signed. Many of us also called state and federal agencies to make [illegible] the program was sound. No one said it was risky business.

We call ourselves trustors. We are not investors because we were not gambling in the fortunes of FITCO. Our return was limited to T-bill interest plus one and a quarter percent. In the last full year of the program this averaged only eight percent. We are not stockholders, we could never profit from the operation of FITCO, in fact we are forbidden by law from managing our own accounts or knowing what FITCO was really doing with our money. We were people who accepted only a predictable return guaranteed against the company's default by federal insurance.

What we did get for our money was the knowledge that we were helping students. FITCO assigned our accounts to individual students -- there are graduates walking around out there with Greg Voelm loans. Even at eight percent, it seemed like such a good safe investment that I put $120,000 into students loans. In Washington that may not be a big number. But in my life it is most of the money I have in the world. Many people put up their entire life savings: the student loan program attracted almost $30,000,000 from trustors.

In return for our money, we got a guarantee in writing. I will read it to you now (Exhibit A):

> "[the program bears] the full faith and credit of the U.S. Government ... the highest priority guarantee for a financial instrument; safer than the FDIC or FSLIC."

The legal documents establishing our trusts reinforced this guarantee (Exhibits B and C)

> "[the principal will be] invested and reinvested by the Trustee in obligations fully insured or guaranteed by the United States Government for which the full faith and credit of the United States is pledged."
>
> "The undersigned Trustor understands that, to retain their guaranteed status, reinsured status or full faith and credit status, these obligations may be held only in the name of First Independent Trust Company, an eligible lender who has been approved by the United States to hold the same."

Over the entrance to the main headquarters of FITCO were these words (Exhibit D):

"EDUCATION IS THE SAFEST INVESTMENT"

They are a quote from the President of First Independent Trust, Dino Evangelista.

FITCO was an approved lender under the Student Loan Program, in fact the third largest lender in the United States. FITCO was regularly audited by the U.S. Department of Education. If this were not enough, the financial institution was also chartered and regularly audited by the California Banking Department (see Exhibit E). Sadly, as you now know, the government knew about abuses at FITCO and failed for years to take effective action. They never warned the trustors.

What we have since learned is that a special Inspector General's team from the DOE in Washington audited the company in 1987 based on documentation Jack Keefe had gathered by 1986. They found that First Independent owed the government 1.12 million dollars for interest paid on refunds and cancellations from 1984 through 1986 alone. But the regulators never told the public, they never collected the money, and they didn't stop First Independent. Several months ago when I spoke with the Department of Education about their management of the problem, their response was "we're so busy, how can we keep track of each company?" Officials now say the company

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State Banking regulators conducted audits of First Independent which reportedly showed serious trouble, but they never told the public and they didn't stop the company until the State finally closed FITCO completely in May of 1989. Even then it wasn't because of the failure to pay the fees. It was because of the UES failure.

This lack of courage and responsibility has caused people to cry and suffer and fear for their children. I will tell you four stories:

A young mother wrote Secretary Cavazos shortly after the FITCO collapse. Her letter said, in part:

> "I am pregnant with our first child. I work on a commission basis and do not have health insurance through my company. Our health insurance was our savings in First Independent Trust Company. I have been saving this money to cover medical expenses and other costs we will have as a result of the addition to our family. We worked hard and sacrificed to save and put all of our savings into FITCO. Now we have been forced into the financial situation that we worked so hard to avoid. We have no cash to cover medical expenses or other emergencies."

One of our members was a pretty good boxer a few years ago. He was a contender for the W B A welterweight crown. Now he works for the Corrections Department. All his savings were in student loans.

If you've ever watched a boxing match you know you can get hurt, even if you're good. Imagine pushing yourself out to fight again and again and again, even though your mouth is cut and your eye is half swollen shut. Now think about having everything for which you bled taken away by someone who doesn't even have the courage to face you.

For years Margaret Chase's husband withheld part of his pay to protect them when they were older. They put their retirement savings into FITCO. Three years ago her husband died and left Margaret alone. She's been trying to get a job since her savings were frozen but that is hard to do when you are 75.

None of the trustors have been able to get to their savings since May of 1989. To make the damage even worse, the Department of Education is still insisting that the trustors come up with 4.4 million dollars to cover guarantee fees that the Department failed to collect from FITCO. The State of California has already spent millions of dollars and thousands of hours trying to satisfy the demands of the Student Loan Program. It has been a year and a half. Three of our older trustors have died without their money.

Carole Percival is still hanging on. She had cancer surgery three years ago. Although the $50,000 represents a significant part of her retirement savings, she says she isn't as concerned about herself as she is about her children, ages 8 and 12. She doesn't see how they are going to get to college without her help.

Ladies and gentlemen, please take the steps necessary to clean up this program. After all that has happened to us we still believe in giving a chance to young people who need an education. But we don't need a program that underwrites schools with a history of high student loan defaults. Loans are not grants. They are moral and legal obligations. Use this program to make America a better place.

For us this tragedy can end now. Secretary Cavazos has the authority to declare our portfolio whole without the payment of extortionary charges. Richard Hawk, Chairman of the Board of HEAF, has assured me that he is prepared to honor all guarantees at the direction of Secretary Cavazos. If the Department can get SLMA to grant HEAF over a half billion dollars in "loans", it can give us our money back.

We are the only people in the history of the Program who put up their own money to make student loans. We have no responsibility for the Department's troubles with FITCO, Bank of America, UES or HEAF. We do not deserve to suffer for believing in the goals of the Student Loan Program.

Please help us. Even more than getting my money back, I want to be able to tell my son Jonathan that his government is fair and responsible.

EXHIBIT A

First Independent Trust Company

First Independent Trust
The INTRUST BANK

1020 12th Street
Sacramento CA 95814
(916) 441-3031

Full Trust Services · Personal · Estate · Pension

February 17, 1984

R. Templeman
3112 Lathamia
El Dorado Hills, CA 95630

Dear Mr. Templeman:

First Independent Trust, The INTRUST Bank, has continued to outperform the money market funds, bank and savings and loan, CDs, and money market rates with Trust Rate.

First Independent Trust offers the best rate in town on comparable money markets.

	Annual Rate	Annual Yield
First Independent Trust	10.76%	11.20%
Sacramento Valley Bank	9.25%	9.625%
Capital Federal	8.75%	9.143%
Bank of America	8.40%	8.731%
Crocker	8.40%	8.731%
Great Western	8.55%	not available
Sacramento Savings	8.65%	9.034%
Wells Fargo	8.40%	8.787%

In addition, the average for 1 year accounts at banks and savings and loan in the Sacramento area is 9.74.

This is based on an independent survey as of February 10, 1984, for one (1) year accounts of $2,500 or more by Bank of America, Crocker, Wells Fargo, Security Pacific, First Interstate, Great Western, Home Savings, American Savings, Glendale Federal, and California Federal Savings.

Trust Rate is currently earning 10.76% with a yield of 11.20% compounded quarterly.

Trust Rate is determined by the average of the 91-day T-Bill rate, plus 2%.

The guarantee on Trust Rate is the full faith and credit of the U. S. Government, which is exactly the guarantee given if you were to purchase T-Bills. Also, the full faith and credit of the U. S. Government is the highest priority guarantee for a financial instrument; safer than the FDIC or FSLIC which are secondary to the full faith and credit of the U. S. Government.

Reply to:
P.O. Box 2310
Sacramento, CA 95811

1020 12TH STREET • SACRAMENTO, CA 95814 • PHONE (916) 441-3031

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*TIME TRUST**

EXHIBIT B

This agreement between the undersigned TRUSTOR, and First Independent Trust Company, a bank authorized to transact a trust banking business under the laws of the State of California, TRUSTEE, hereby establish this trust for the purpose of providing a program through which the TRUSTOR may acquire an interest in certain qualified notes hereinafter specifically referred to and/or United States Government obligations. The specific investments permissible under this trust are those which are listed in the acceptable securities list of the United States Treasury Department's Regulations governing Special Depositaries of Public Money and eligible as collateral security at face value. In consideration of the terms and conditions set forth herein, TRUSTOR and TRUSTEE agree:

I. FUNDS HELD IN TRUST - The Trustor has transferred and delivered to the Trustee, IN TRUST, the property described in the Letter of Instructions, signed by the Trustor and incorporated herein by reference. This property and any additional property hereafter delivered to Trustee, shall be administered by the Trustee in accordance with the terms and conditions hereof.

II. DISTRIBUTION OF INCOME - At the conclusion of each program, the Trustee shall distribute the income of the trust as the Trustor shall direct in writing. The Trustor understands that there may be additional income received after termination of the trust.

III. INVESTMENTS - The principal of the trust may be held on deposit in insured banks licensed by any state government within the United States or the United States Government, and invested and reinvested by the Trustee in obligations fully insured or guaranteed by the United States Government for which the full faith and credit of the United States is pledged.

IV. NON-ASSIGNABILITY - The parties hereto agree that the Trustee shall not deliver over nor permit any loan or security to be transferred, pledged or assigned, nor may an assignment be made of any note in this trust as security to any person, company, institution, corporation or individual during the period of the trust by the Trustor or by any other beneficiary.

V. COMPENSATION AND RESIGNATION - The Trustee shall be entitled to compensation as agreed. The Trustee shall be entitled to reimbursement by Trustor for expenses, including legal fees, incurred by it in the administration of the trust estate. The Trustee may resign by giving 30 days written notice thereof delivered to the Trustor whereupon this trust shall terminate.

VI. POWERS RESERVED BY TRUSTOR - The Trustor reserves the right by written direction to the Trustee, subject to the Trustee's approval, to direct investments of the principal of this trust in any legal investment. The Trustee is specifically authorized to invest in common investment funds the corpus of which is composed solely of obligations for which the full faith and credit of the United States is pledged. The Trustor reserves the right to terminate the trust by written notice delivered to the Trustee. Trustor shall allow Trustee a period not to exceed three months from date of notice of termination to Trustee to complete any commitments entered into by Trustee and to convert the trust investments to cash.

EXHIBIT A-9

TIME TRUST - The trade mark of FITC, for its time managed programs.

[illegible]

EXHIBIT C

LETTER OF INSTRUCTIONS & MEMORANDUM OF UNDERSTANDING

TO: First Independent Trust Company, TRUSTEE
1030 12th Street
Sacramento, CA 95816

It is my understanding that First Independent Trust Company has established a Trust Rate Program into which individually managed trust accounts may be directed for the investment of their funds. All investments of this Program are guaranteed by the State of California, are reinsured, or are full faith and credit obligations of the United States Government.

The undersigned Trustor understands that, to retain their guaranteed status, reinsured status or full faith and credit status, these obligations may be held only in the name of First Independent Trust Company, an eligible lender who has been approved by the United States Government to hold the same.

I am desirous of obtaining a beneficial interest in the above obligations now owned or acquired in the future by you. Having full knowledge that legal title may be held only in your name and, further, knowing that a trustee may not use or deal with trust property for his own profit, and of all other facts that might affect my decision, nevertheless, having the capacity to contract, and not acting under the undue influence of the Trustee, I hereby authorize First Independent Trust Company to purchase, sell, and to otherwise deal with the assets of the undersigned Trustor and to distribute the profits therefrom as described in paragraphs four and five of the trust agreement attached hereto and made a part hereof by reference.

I understand that this Program guarantees a net return to my trust of a TRUST RATE of 2% in excess of the average 91-day Treasury Bill weekly auction rate. A portion of the interest under this Program requires billing to the U. S. Government. Such interest, although earned, will be credited to my trust account when received by the Trustee.

I further understand the Trustee's fees shall be charged at a variable rate per quarter, or any part thereof, based on the earning value of the assets during the quarter. Trustee's fee shall be an amount equal to not more than the total earnings of the assets, less a sum equal to 2% in excess of the average 91-day Treasury Bill weekly auction rate.

This Letter of Instructions, cancelable by me on 30 days written notice, directs you, as my Trustee, to invest $[redacted] of the funds now in my account in your Trust Rate Program together [redacted] therefrom and any subsequent capital additions thereto.

[redacted]

ACCEPTED:
First Independent Trust Company, TRUSTEE

By: [redacted]
Authorized Signature

Dated Oct 25, 19 83

EXHIBIT B-3

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EDUCATION IS THE SAFEST INVESTMENT

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EXHIBIT E

AN OVERVIEW OF FIRST INDEPENDENT TRUST COMPANY, A CALIFORNIA BANKING CORPORATION, CHARTER #1136.

IN OUR 10TH YEAR OF SERVICE TO CALIFORNIA

Incorporated in the State of California and received its State Banking Charter in August, 1975, First Independent Trust Company exercises trust powers granted under State Banking Law. Its primary functions thereunder are the administration of decedent's estates, guardianships of minors, conservatorships for adults, testamentary, and private trusts and agencies in the personal trust area, pension and profit sharing trusts for corporations, along with IRAs and Keoghs for individuals in the pension trust area.

As a trust banking corporation, we are required by law to deposit with the State Treasurer money or securities having a market value of up to $500,000.00 as security for the faithful performance and execution of all court and private trusts accepted by us. State banking laws provide for the examination of all securities, books, records and accounts as often as the Superintendent of Banks deems advisable. We conduct our business under the supervision of the State Banking Department, and in accordance with the regulations of the Comptroller of the Currency and applicable State Law.

First Independent Trust Company, while it does have many large accounts, has focused its efforts in serving the middle range of trust clients, $50,000 - $500,000, where the major banks have priced themselves out of this market. The range of accounts now handled by First Independent, dollar-wise, start with the $2,000 IRA and range through a $1.5 million court trust to a $5 million pension and welfare trust.

First Independent Trust Company is the eighth largest lender under the California Guaranteed Student Loan Program nationally, and at present, the only State Bank in the "CLAS" Loan Program for students and their parents. First Independent Trust Company is the only bank nationally using trust monies to fund these Government Guaranteed Student Loans through their investment programs for trusts.

Our entire staff, which now numbers 47, are well-trained and seasoned employees insuring the proper administration of all accounts. A fully computerized accounting facility provides for an accounting and reporting system of superior quality. Our 7 key employees and officers, collectively, represent over 200 years of Trust expertise, the greatest in the Valley.

First Independent Trust Company, 1020 12th Street, Sacramento, CA 95814
Phone (916) 441-3031

FITCO Student Loan Disaster

June 20, 1990

FROM: Student Loan Trust Task Force Committee

Objective

Our goal is to obtain restitution for those who had deposits in First Independent Trust Company (FITCO), at the time of its closure on May 19, 1989. The devastating effect of that closure was to abduct the life savings of thousands of people who had relied on the federal government and the State of California to protect them. Unfortunately, the agencies were not minding the store. The primary steps that should be taken to return those savings are:

1. The Federal Department of Education (DOE) should accept the results of its own mismanagement by honoring loan guarantees for loans generated by FITCO without trying to collect past due fees from innocent Trustors. DOE failed to collect those fees, even though the Department knew FITCO was withholding them. The DOE should pursue the principals who owned and operated FITCO and the other private parties responsible for the disaster, rather than the depositors who did not and could not have known that DOE wasn't receiving its loan guarantee payments.

2. Based on:

   a. The California Banking Department's (CBD's) knowledge of FITCO representations that deposits were guaranteed by the State and/or Federal Government,
   b. CBD's failure to stop FITCO from making such representations, and
   c. CBD's failure to alert potential and existing customers to FITCO's problems with DOE insurance,

   the State of California should guarantee the trust rate loans and take over any claims by individual trustors against the DOE and any private financial institutions which may have been responsible for the FITCO collapse.

3. If DOE insists on making other parties pay for its negligence, then the $4.4 million DOE is trying to extract from non-FITCO entities should be distributed between the financial institutions and the agencies responsible for the problem.

Background

It has been over one year since the California State Banking Department closed FITCO, started liquidation proceedings, and froze Trustor assets. The 25,000± people who had funds held in "Trust Rate" accounts at FITCO have no idea when, how much, or if any of their savings will be returned. The human tragedy is not limited to families who have lost their future retirement savings, but also extends to:

1. Individuals in active retirement who have been thrown onto the welfare rolls.
2. Parents who have lost the funds they were saving to pay for their own children's education.
3. People in need of medical care who have been denied the treatment.

4. Immigrants who had been told they were protected by the full faith and credit of the U.S. government who now feel they have been betrayed by their new government.
5. Trustors who have lost homes because assets needed for payments have been frozen.

A great deal has been learned about the role of the agencies involved in this financial tragedy:

1. The DOE knew as early as 1985 that FITCO was not in compliance with the federal regulations governing student loans. Even so, in 1986 DOE helped FITCO obtain special legislation in Congress to participate in the student loan program.

2. The DOE and the CBD both knew that FITCO had been advertising since 1983 that trust deposits were guaranteed by the State of California or backed by the "full faith and credit of the United States."

3. Following the DOE's own Inspector General audit in 1987 that revealed the unpaid loan origination fees, DOE failed both to enforce the assessments it levied against FITCO for those back fees and to ensure that future payments were made.

4. From time to time over the life of the FITCO student loan program, California banks regulated by the CBD used FITCO as a short term repository for surplus funds (float, etc.). These banks were under the continuous scrutiny and audit of the Department. As far as we know, the Department never even told those banks that FITCO was an unsafe repository for such bank funds or that FITCO was completely uninsured, a high risk, or not acceptable under the California banking regulations for such deposits. If the banks didn't know, how were individual depositors to know they were going to lose their life savings?

The FITCO disaster exists because of lack of proper supervision by the State Banking Department, Department of Education, and other agencies of government whose responsibility it was to monitor FITCO and the student loan program. Citizens trusted their government and the government let them down.

Who are the players?

First Independent Trust Company (FITCO):

A trust company in Sacramento since 1975, engaged in the business of serving as trustee for fiduciary accounts. Its principal account was a trust rate account used exclusively for making student loans. According to FITCO documentation, **which was reviewed by the state and federal government**, FITCO's investments in these student loans were guaranteed by the State of California or were "full faith and credit" obligations of the U.S. government. FITCO's request to be identified as a bank was originally turned down by the State Banking Department. However, in 1986 FITCO obtained special legislation with the help of DOE, despite the knowledge that FITCO had had serious problems in 1985. FITCO certainly helped DOE. At more than $1.5 billion dollars in loans, FITCO was DOE's third largest lender.

Deno Evangelista: President and chairman of FITCO since it opened in 1975.

D. Glen Bigelow: Executive Vice President of FITCO
Jon Smock: Legal advisor and director of FITCO
Parent Holding Company: Lawyers Financial Corporation

Trustors:

The 25,000± individuals, families, and institutions who have trust accounts containing federally guaranteed student loans. The Trustors gave their money to FITCO, who acted as trustee and invested the money in federally guaranteed student loans. The Trustors' deposits were reinvested in student loans which, over the years, provided loans for some 250,000 students throughout the country. Trustors were prohibited by law from participating in the management of the trust accounts.

Student Loan Trust Task Force (SLTTF):

The SLTTF is the volunteer organization of Trustors who are actively working to secure the release of trust assets. It is composed of district directors responsible for communication to the members, and committees responsible for work on publicity, political assistance, legal options, etc. There are 600+ active members. The principal organizer is Greg Voelm.

United Education Software (UES)

UES was a Los Angeles area based corporation that played both sides of the student loan program. On the front end, they owned what the *Los Angeles Times* described as a "sleepy chain of vocational schools" in 1984. In conjunction with FITCO, UES schools sent student loans to FITCO for processing. After disbursing the loans, FITCO in turn sold the loans to the CSLFC (see below), a private secondary market for student loans. CSLFC, in turn, selected Bank of America (B of A) as its bank trustee. B of A contracted with UES to service (collect) the loans.

With the easily-attainable, federally guaranteed student loans and FITCO's aggressive marketing, both sides of the UES business grew rapidly. Over 3 - 4 years FITCO processed and disbursed nearly $1.5 billion in loans from UES and many other schools. Almost all of FITCO's loans were sold to CSLFC and turned over to UES for servicing. A question has arisen about the close relationship that existed between some of the individuals who were links in the chain between UES schools, FITCO, CSLFC, Bank of America, and UES servicing.

California State Banking Department (CBD):

This regulatory agency of the state licensed and audited FITCO prior to closing it in May 1989. The State Banking Department said it was necessary to close FITCO because FITCO was operating with substantial losses. As indicated above, CBD was aware of the pending disaster for several years prior to its closure of FITCO, but it did not correct the situation or alert potential victims. CBD was also aware of FITCO's claims to lure Trustor's money, but did nothing to stop false representations by FITCO.

Department of Education (DOE):

DOE is the agency responsible for administering and guaranteeing the student loan program. It approved and audited FITCO's performance under the program. DOE officials failed to collect the loan guarantee fees which were owed to the department under the federal regulations for the program. DOE now refuses to reinstate the guarantees on loans made by FITCO unless the past due fees are paid out of the Trustors' funds. It is outrageous to expect the Trustors to be responsible for the guarantee fees. The Trustors had no knowledge of FITCO's business or any responsibility or means to see if FITCO had paid the fees. In fact, who would know better than the DOE if these fees were in arrears? DOE, not the Trustors, was supposed to serve as the watch dog of the student loan program. DOE has finally proposed that if the Trustors are willing to pay $4.4 million, the DOE guarantee will be reinstated. This means that loans held by Bank of America and backed by several large Japanese banks as well as loans held by West Texas and CHELA would also be guaranteed. Under the current proposal a grossly disproportionate amount of the fees would be paid by FITCO Trustors when, in fact, Trustors should not be responsible for paying further fees. Even with the payment of the $4.4 million to DOE, there may be other problems with the loans.

Higher Education Assistance Foundation (HEAF):

HEAF is a student loan guarantee corporation that is reinsured and licensed by DOE. When a loan goes into default, a claim for payment of the loan under the guarantee is filed with HEAF. Assuming all requirements are met, the claim is processed and paid by HEAF. HEAF is then reimbursed by DOE. The current rate of reimbursement from DOE to HEAF is 80%. However, HEAF now claims that FITCO loans are in question even if DOE agrees to guarantee the loans. HEAF does not want to guarantee loans made by FITCO unless a number of unrealistic procedures are followed. HEAF refuses to cooperate with the State Banking Department in any way to resolve the problem. HEAF won't even answer letters and phone calls. They are looking for technical excuses to deny guaranteeing loans. Problems that HEAF has with FITCO are not a justification to default on the loans in the trust accounts of the Trustors.

California Student Aid Commission (CSAC):

CSAC is the state agency designated by DOE to administer the student loan program in California. CSAC licensed FITCO's participation in the program and was responsible for auditing FITCO's and Bank of America's performance under the state and federal regulations.

California Student Loan Finance Corporation (CSLFC):

CSLFC is a secondary market institution that purchased loans from FITCO. It holds the largest amount of student loans on which origination fees were not paid (approximately 70%). CSLFC has purchased $8.1 million held in trust accounts of student loan second disbursements. CSLFC selected Bank of America as their trustee bank for the student loan program. The executive vice president of CSLFC ran the Bank of America Student Loan Program before joining CSLFC. The *Los Angeles Times* has reported the President of CSLFC to be a close personal friend of the President of UES.

Bank of America (B of A):

B of A is the trustee of the bonds used to buy the student loans. On behalf of other major international banks, it currently holds more than $222 million in defective student loans from the FITCO collapse. Bank of America used UES to service its loans. DOE has stated that B of A failed to exercise due diligence in servicing its student loans. B of A reported more than $1 billion dollars on profits last year.

Major Japanese Banks:

Mitsubishi Bank, Industrial Bank of Japan, Bank of Tokyo, Mitsubishi Trust and Banking, Fuji Bank, Dai-Ichi Kangyo Bank, and Sanwa Bank, backed the student loan bonds with letters of credit. They blame Bank of America for causing the student loan disaster through mismanagement.

West Texas Higher Education Authority (WTHEA):

WTHEA is a corporation set up to provide a secondary market for government-guaranteed student loans.

California Higher Education Loan Authority (CHELA):

CHELA is also a corporation set up to provide a secondary market for government-guaranteed student loans.

WTHEA and CHELA hold loans made by FITCO on which origination fees were not paid. They hold 10.6% and 8.2% respectively. Even though they represent nearly 20% of the loans at risk they do not want to make a proportionate contribution.

All of the secondary market institutions have been asked to contribute to the $4.4 million DOE is demanding to make these loans good and all have declined to fully participate in paying their fair share. The State Banking Department has determined that the Trustors' share of the DOE settlement would be only $338,000 if the Trustors were only covering the loans in the FITCO portfolio at the time of the closure. Yet the Trustors are being charged a much higher percentage of the $4.4 million to cure the loans. Again, Trustors should not be responsible for additional fees. DOE is holding the trust accounts and legitimate interest payments hostage until it gets paid.

Summary

The basic problem in this terrible situation is that no regulatory agency wants to accept the responsibility for this failure. No one wants to get down to the bottom line and find out where, why, and who was negligent. In response to letter writing campaigns by the Student Loan Trust Task Force to Congressmen, Senators, heads of regulatory agencies, etc., many opinion leaders have expressed sympathy, understanding, and concern. Many of them have actively supported what they see as a just cause to protect the public from unscrupulous financial institutions and negligent regulatory agencies. The word needs to get out that your money is not safe if federal regulators are not taking their jobs seriously.

The cost of this disaster should not fall on the innocent individual Trustor victims. A major portion of the responsibility should be borne by the federal agency that failed for years to collect the loan origination fees even while it knew those fees were overdue. In addition, any private parties responsible for this disaster should be held legally liable for the damage. Lastly, a sense of justice dictates that the major financial institutions in the student loan business, holding the majority of the bad loans, should pay their proportionate share.

Unlike the problem with the Savings & Loan industry, the student loans are still as valuable as they were before the FITCO collapse. The Trustors relied on the "good faith and credit of the United States," and helped 250,000 students get an education. Now those Trustors want the government to give them their savings back.

BEST COPY AVAILABLE

STATEMENT OF JAMES E. GILLERAN, SUPERINTENDENT OF BANKS OF STATE OF CALIFORNIA, BEFORE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF U.S. SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

September 26, 1990

I. INTRODUCTION.

I am pleased to be here today to provide information to the Subcommittee regarding its investigation of the federal student loan program. The program plays an important role not only in the educational system but also in the financial system, and it is important for all concerned with the program, including financial institutions participating in the program and their regulators, that the program function properly. Also, as the official who is liquidating First Independent Trust Company ("FITCO") and safeguarding the interests of the members of the public who invested their funds in student loans through FITCO, I am directly interested in seeing that any problems in the student loan program are identified and corrected.

By way of introduction, I should note that I was appointed Superintendent of Banks of the State of California on July 5, 1989. Immediately before my appointment, I was the president of an investment banking firm in San Francisco, California. However, my career has been as a certified public accountant, mainly with Peat, Marwick, Main & Co. I retired from Peat, Marwick in 1987, having been the managing partner of the firm's San Francisco office.

The California State Banking Department ("SBD") regulates 267 state-chartered commercial banks with total assets of $103 billion. (Figures in this statement are rounded and approximate. Data regarding SBD's licensees are as of June 30, 1990.) SBD also supervises 20 state-chartered trust companies which, together with the 37 state-chartered banks that have trust departments, hold $128 billion in fiduciary assets. In addition, SBD oversees 102 branch and agency offices of foreign banks with total assets of $84 billion, plus 95 representative offices of foreign banks. Also subject to SDB's jurisdiction are issuers of money orders and travelers checks, transmitters of money to foreign countries, and business and industrial development corporations. SBD has a staff of 190, including 85 examiners.

Your letter inviting me to testify asked me to present a history of FITCO from the perspective of the regulator. FITCO was closed and placed in liquidation by SBD on May 19, 1989. That was almost two months before I took office as Superintendent of Banks. Consequently, I do not have first-hand knowledge of FITCO's operations or of the events that led up to the closing. However, I have been actively engaged in overseeing the liquidation of FITCO, and through that effort I have gained some knowledge of the problems that developed at FITCO. In addition, in preparation for my testimony here today, I have made a limited review of FITCO's history. As you will understand, we are concentrating our resources on liquidating FITCO and safeguarding the assets that it held in trust. Once we reach a plateau in the liquidation, I plan to make a thorough review of the case to determine what we can learn from the FITCO failure and what steps we can take to make sure it does not happen again. For the present, I believe I have gathered together sufficient information to respond to your request and fulfill the Subcommittee's needs.

With that qualification, then, let me recount for you the history of FITCO from a regulator's perspective. As the Subcommittee's staff suggested, I will begin with an explanation of what a California state-chartered trust company is and how it is regulated. Then, I will describe how FITCO was licensed, how it ran its student loan business, and how it came to fail. Finally, I will identify the problems that we encountered after closing FITCO and give you a report on how we are resolving those problems in the liquidation.

II. CALIFORNIA STATE-CHARTERED TRUST COMPANIES.

Let me first address the subject of California state-chartered trust companies -- how they are created, what they do, and how they are regulated.

There are three types of entities that may transact trust business under the jurisdiction of SBD; namely, the trust department of a commercial bank, the trust department of a title insurance and trust company, and what we call a "independent trust company." California Financial Code ("Cal. Fin. C.") Section 107; 10 California Code of Regulations Sections 10.138 and 10.178. FITCO was in the third category, independent trust company. Therefore, I will focus on that type of institution here, and for convenience I will refer to it simply as a "trust company."

A person who wishes to organize a trust company must apply to SBD for approval. Cal. Fin. C. Sections 350 and 360. SBD makes an investigation of the application to determine, among other factors, whether the establishment of the trust company will promote the public convenience and advantage, whether there is a reasonable promise of successful operation, whether the proposed capital structure is adequate, and whether the proposed directors and officers have sufficient experience, ability, and standing. Cal. Fin. C. Sections 361 and 362. If SBD makes favorable findings on the factors, it approves the application, and the applicant incorporates the trust company. Cal. Fin. C. Sections 362 and 400. The trust company then goes through the organizational process, appointing officers, selling stock in order to raise capital, setting up its office, and otherwise getting ready to open for business. When the organizational process is completed, SBD issues the trust company a certificate of authorization to transact business as a trust company, and the trust company commences business. Cal. Fin. C. Section 401.

A trust company typically focuses on one or more lines of trust business, depending on its business plan. The lines of business include personal trust business (for example, executor of testamentary estates, trustee of inter vivos trusts, and trustee of Keogh plans and individual retirement plans) and corporate trust business (for example, trustee of bond indentures, registrar and transfer agent for corporate stocks, and trustee of employee benefit trusts).

Strictly speaking, trust companies are not limited to trust business. Under the California General Corporation Law, a trust company may engage in any activity not prohibited by the laws and regulations to which it is subject. California Corporations Code Section 206. Thus, a trust company may engage, for example, in the business of making loans.

Trust companies are regulated by the SBD under the California Banking Law (Division 1 (commencing with Section 99) of the Cal. Fin. C.). For example, changes in the corporate structure of a trust company, such as amendments to articles of incorporation or a merger with another trust company, require SBD's approval, as does an acquisition of control of a trust company. Cal. Fin. C. Sections 600.4, 700 et seq., and 2070 et seq. A trust company's establishment of new offices and the relocation or closing of existing offices are subject to SBD's approval. Cal. Fin. C. Sections 420 et seq. Also, a trust company must obtain a permit from SBD before offering or selling its stock. Cal. Fin. C. Sections 690 et seq. A trust company is required to file financial statements with SBD quarterly. Cal. Fin. C. Section 1930. In addition, a trust company is subject to examination by SBD. Cal. Fin. C. Sections 1900 et seq. SBD is required to examine the so-called "court trust business" of a trust company (i.e., trusts and other fiduciary accounts where the trust company acts under court appointment or court supervision) at least once every two years; and SBD may examine a trust company's so-called "private trust business" (i.e., non-court trust business) whenever it is considered necessary or advisable. Cal. Fin. C. Sections 1581 and 1583.

A trust company may take action or hold property in either of two capacities; namely, as trustee or other fiduciary ("fiduciary capacity") or in its own right and for its own account ("corporate capacity"). A trust company accounts for actions taken and property held in its fiduciary capacity on one set of books and records (the "fiduciary books") and accounts for actions taken and property held in its corporate capacity on a separate set of books and records (the "corporate books"). It is sometimes said, then, that a trust company has two sides, the "fiduciary side" and the "corporate side."

While trust companies are subject to many of the same provisions of the California Banking Law as commercial banks, there are important distinctions between the two types of institutions. The most important distinction is in the authority to accept deposits. Commercial banks are authorized to accept deposits in the general sense of the term (i.e., deposits that give rise to a creditor/debtor relationship). Cal. Fin. C. Sections 102 and 105. Trust companies, on the other hand, have only very restricted authority to take deposits. Specifically, a trust company's authority to take deposits is limited to deposits accepted in a fiduciary or other representative capacity and deposits accepted from a court-appointed fiduciary under court order. Cal. Fin. C. Sections 106, 1580, and 1586. Subject to these narrow exceptions, a trust company may not accept deposits. Consequently, SBD's regulations do not require trust companies to be insured by the Federal Deposit Insurance Corporation.

The question has been asked whether a trust company is a bank. The term "bank," as used in the California Banking Law, is defined as including both commercial banks and trust companies. Cal. Fin. C. Sections 102, 103, and 109. The function of the definition is to establish "bank" as a term of reference including both commercial banks and trust companies for purposes of the California Banking Law. Thus, the regulation of commercial banks and trust companies, both as going concerns and in liquidation, is very similar in California, even though a trust company does not fit within a consumer's concept of a bank.

It should be noted that, shortly after FITCO was closed by SBD, FITCO filed a petition to reorganize under Chapter 11 of the Federal Bankruptcy Code. The U.S. Bankruptcy Court dismissed the petition, finding that FITCO was a "bank" for purposes of the Bankruptcy Code and, therefore, not eligible to file for relief under the Bankruptcy Code. In re First Independent Trust Company, 101 Bankr. 206 (Bankr. E.D. Cal. 1989). The Bankruptcy Court based its decision on two grounds, or tests. First, under the "state classification test," the Bankruptcy Court found that FITCO was classified as a "bank" under the California Banking Law. Second, under the "independent classification test," considering the particular facts of the case, including FITCO's advertising itself as a "bank" and the characteristics of the so-called "trust rate accounts" through which FITCO obtained funds from the public for the purpose of making student loans, the Bankruptcy Court concluded that FITCO was a "bank" for purposes of the Bankruptcy Code. The Bankruptcy Court's dismissal was affirmed by the U.S. District Court for the Eastern District of California (Case No. CV-S-89-890-MLS) and is now on appeal to the U.S. Court of Appeals for the Ninth Circuit.

III. FITCO -- LICENSING.

On January 3, 1974, Lawyers Financial Corporation ("LFC") applied to SBD for authority to organize FITCO. LFC was a California corporation which itself had been incorporated in 1960. The Chairman of the Board and President of LFC was Deno Evangelista, who was also proposed to be the Chief Executive Officer and a director of FITCO. At one time, LFC had registered as a savings and loan holding company with the State of California and held an interest in Loyalty Savings and Loan Association. In 1973, the year before the filing of the application, LFC, as part of the settlement of a lawsuit, sold its interest in the savings and loan association at a substantial gain.

According to the application, FITCO was proposed to emphasize trust services for individuals and institutions in the middle income ranges. Particular efforts were to be focused on Keogh plans, employee benefit plans, and estate planning services.

On June 12, 1974, SBD denied the application for authority to organize FITCO. The reasons given for the denial were that the establishment of FITCO would not promote the public convenience and advantage and that there was not a reasonable promise of successful operation. In addition, SBD believed that the proposed capital structure and management were not adequate. Also, SBD was concerned that FITCO proposed to use the services of an investment advisory firm controlled by Mr. Evangelista.

After the denial of the application, LFC applied for a rehearing. SBD declined to reconsider its denial on the basis that it lacked jurisdiction to change a final decision. However, in an effort to be as fair as possible under the circumstances, SBD reviewed the additional materials submitted with the request for rehearing, but SBD concluded that, even if it had had the additional materials in hand before deciding the application, it would have still denied it.

On December 9, 1974, LFC filed a petition for a writ of mandate in the California Superior Court, requesting the court to order that the application for authority to organize FITCO be granted. While the litigation was pending, LFC proposed substantial changes in the application. The changes included provisions that FITCO employ an additional trust officer, that FITCO not use the services of the investment advisory firm controlled by Mr. Evangelista, and that FITCO purchase an office building from LFC, thereby creating a source of income. The changes also included a revised fee schedule and budget for FITCO as well as presentations on public convenience, profitability, and capital. SBD concluded that, with the changes, the application qualified for approval. Accordingly, SBD stipulated to the entry of a judgment in the litigation. Under the stipulated judgment, SBD's denial of the application was set aside, the changes proposed by LFC were made in the application, and the application with the changes was approved.

On August 8, 1975, FITCO's articles of incorporation were filed with the Secretary of State of the State of California, and FITCO was thereby incorporated. On August 22, 1975, FITCO having completed the organizational process, SBD issued FITCO a certificate of authority to transact trust business.

IV. FITCO -- STUDENT LOAN BUSINESS.

From the commencement of business in 1975 and continuing up to 1980, FITCO engaged in what might be called a conventional trust business, concentrating, as had been indicated in the application for authority to organize, on personal trust business and employee benefit plans for small- and medium-size businesses. In 1980, FITCO expanded into the student loan business.

FITCO's student loan business was unique. As far as SBD is aware, FITCO was the only institution in the United States that used trust funds to make student loans.

The following is a brief description of how FITCO conducted its student loan business. FITCO's student loan operations were changed from time to time. The following description focuses on the operations as they were carried on during the last two years or so before FITCO was closed.

FITCO made student loans both on its fiduciary side and on its corporate side, and the two systems differed from each other in some respects. This is how the system worked on the fiduciary side:

FITCO solicited and accepted funds for what it called "trust rate accounts." The persons who placed funds in trust rate accounts (the "customers") were mainly individuals but included some businesses and even a few commercial banks.

When a customer opened a trust rate account, the customer and FITCO signed certain documents. The document forms were revised several times, but most often consisted of a declaration of trust and a letter of instructions (collectively, the "trust rate contract"). The trust rate contract provided for the funds to be held by FITCO as trustee, with the customer as settlor and beneficiary, and authorized FITCO to invest the funds in student loans which were insured under the Guaranteed Student Loan Program established pursuant to the Higher Education Act of 1965 and eligible for resale to the Student Loan Marketing Association.

FITCO used the funds in the trust rate accounts to make student loans. FITCO developed a network of contacts with schools to generate applications for student loans. Most of the schools were not traditional four-year-colleges or universities but rather proprietary and vocational schools. To process the applications, FITCO built up a large staff of personnel, acquired computer equipment, and leased space at a former school in Carmichael, California, which had been converted into an office complex.

When FITCO made a student loan, it withheld from the proceeds of the loan an amount up to three percent of the loan to be paid as a guarantee premium to the guarantee agency which guaranteed the loan, and, in addition, in the case of so-called "Guaranteed Student Loans" or "Stafford Loans," an amount equal to five percent of the loan as an origination fee to be paid to the U.S. Department of Education ("ED"). At the end of each month, these funds were transferred from the fiduciary side to the corporate side of FITCO. The money was typically used to fund the making of additional student loans.

Once FITCO made a student loan, FITCO usually held the loan for only a short period of time and then sold the loan in a block with a large number of other student loans to an institution in the secondary market. The sale price for a student loan was typically the unpaid principal amount of the loan plus a so-called "transfer fee" equal to one percent of the unpaid principal amount.

FITCO received income on the student loans for the time that it held them. In the case of so-called "Guaranteed Student Loans" or "Stafford Loans," the income consisted of the interest benefit and special allowance payment ("IB&SAP") paid by ED at a rate equal to the sum of (i) the average discount rate on 13-week U.S. Treasury bills plus (ii) 3.25 percent.

The customers were paid income on their trust rate accounts at the rate specified in their trust rate contracts (the "contract rate"). When FITCO first started the trust rate program, different forms of trust rate contracts prescribed different formulae for the contract rate. As of January 1, 1988, however, the contract rate was pretty much standardized at a rate equal to the sum of (i) the average discount rate on 13-week U.S. Treasury bills plus (ii) 1 percent. Under the trust rate contract, all income earned on trust rate account assets above and beyond the contract rate was to be retained by FITCO as its trustee's fee.

In mid-1986, FITCO developed the ability to allocate student loans among the trust rate accounts so that each student loan could be assigned to a particular trust rate account and each trust rate account thus could own specific student loans. However, it appears that FITCO did not in fact allocate the student loans on a daily basis. FITCO was never able to allocate income among the trust rate accounts.

In addition to making student loans on its fiduciary side, FITCO made student loans on its corporate side. This is how the system on the corporate side differed from the system on the fiduciary side:

Applications for student loans were processed, not at FITCO by its own staff, but rather at United Education Software ("UES"). Disbursements were also handled by UES. FITCO supplied UES with blank checks for disbursing the proceeds of student loans. Each day, UES would contact FITCO by telephone and inform FITCO of the aggregate amount of the disbursement checks to be issued.

To obtain money to fund the making of student loans through UES, FITCO's corporate side sometimes borrowed from the trust rate accounts on the fiduciary side. On other occasions, FITCO funded the student loans through a process whereby FITCO would sell the student loans immediately after they were made and deposit the buyer's check in the bank account against which the disbursement checks were drawn, thus covering the disbursement checks before they were presented to the drawee bank for payment.

All the income earned on student loans made on the corporate side was retained by FITCO.

Significant problems in FITCO's student loan operations were first identified in the examination that SBD commenced on August 31, 1985. Additional problems were identified in subsequent examinations. The problems included the following:

- FITCO advertised the trust rate accounts as if they were commercial bank deposits. Also, FITCO called itself a "bank."
- FITCO departed from usual trust procedures in administering the trust rate accounts. For example, FITCO did not earmark fiduciary assets (i.e., did not hold record title to fiduciary assets as "trustee"), nor did FITCO provide accountings in the typical form to customers. Also, SBD was concerned with FITCO's handling of income and cash flow in the trust rate system.
- FITCO's operations were deficient. For example, it failed to reconcile its bank accounts and internal accounts on a timely basis.
- SBD questioned whether FITCO qualified as an eligible lender under the Higher Education Act of 1965. For FITCO to be an eligible lender pursuant to the relevant provisions of Section 435(d) of the Act as in effect in 1986, FITCO should have been a state-chartered bank and the making of student loans should not have been its primary consumer credit function.

In an effort to correct the problems, SBD examined FITCO on approximately an annual basis after the 1985 examination. In addition, SBD made visitations from time to time, where an examiner or small group of examiners visited FITCO's offices for a short period to check on specific facets of its operations or its condition. Also, SBD held several meetings with FITCO and its attorneys and corresponded at length with them. Ultimately, SBD aimed to have FITCO enter into a written agreement spelling out rules for its administration of the trust rate accounts and other matters. Although SBD and FITCO appeared in mid-1988 to reach an understanding on most of the concepts for such an agreement, FITCO refused to accept SBD's form of definitive agreement, and the form of definitive agreement was still at issue when FITCO was closed.

SBD's efforts to correct the deficiencies in FITCO's student loan operations met with lack of cooperation on some points and absolute resistance on others. Nonetheless, SBD was able to achieve corrections in some areas, though not in all.

In regard to advertising, FITCO insisted almost to the end that it was entitled to call itself a "bank." Indeed, in August 1986, FITCO filed suit against SBD in the California Superior Court, alleging that it was a victim of SBD harassment and seeking a declaratory judgment that it was not per se misleading or unlawful to call itself a "bank." On the other hand, FITCO stopped the other advertisements to which SBD objected, and it distributed to the customers a brochure giving clarifying information on key questions about the trust rate program.

In regard to administration of the trust rate accounts, some improvements were made. For example, all assets of the trust rate accounts, except student loans, were earmarked, and provisions of the trust rate contracts relating to income and FITCO's fees were amended and clarified.

In regard to operations, the results were mixed. At times, significant progress was made. However, FITCO failed to maintain the progress and ultimately lapsed back into its deficient ways.

On the issue of eligibility, ED and CSAC took the position that FITCO was an eligible lender under the student loan program. Eventually, Section 435(d) of the Higher Education Act of 1965 was amended to, in effect, confirm FITCO's eligibility and eliminate the bases for the questions that SBD had raised.

FITCO derived its profits principally from originating student loans and built a production capacity in the form of employees, space, and equipment to originate a large volume of student loans. FITCO relied mainly on the Higher Education Assistance Foundation ("HEAF") to guarantee loans outside California. In mid-1988, HEAF withdrew from guaranteeing loans in several states. Although FITCO ultimately managed to make arrangements with other guarantors to guarantee loans in those states, that took time, and HEAF's withdrawal forced FITCO to cut back on its volume. Also, the UES crisis arose, and the California Student Loan Finance Corporation ("CSLFC"), which had been the largest purchaser of student loans originated by FITCO, stopped buying. Eventually, other secondary markets also stopped buying. No longer able to sell student loans in the secondary market, FITCO had little cash for originating new student loans. As a result, the volume of originations was reduced to a minimum, and FITCO's production capacity to originate a large volume of student loans became largely surplus. On the other hand, FITCO was forced to continue to hold student loans to the point where they required servicing, but it did not have the capacity to service the loans.

In short, then, FITCO's source of profits, originating student loans, dried up, but the origination expenses continued and servicing expenses were added. This combination produced large operating losses that ultimately exhausted FITCO's shareholders' equity.

On April 13, 1989, SBD commenced what was to be the last examination of FITCO. SBD found that tangible shareholders' equity, after SBD's adjustments, was deficit by $306,000. On May 4, 1989, SBD met with FITCO and prescribed requirements for replenishing shareholders' equity in three steps, with the first step of $566,000 due by May 11, 1989. FITCO failed to meet the capital requirement, and SBD took possession on May 19, 1989.

It would be premature to attempt to define with certainty all the causes of FITCO's failure. However, SBD has concluded that FITCO's management was culpable. Accordingly, SBD has commenced a civil action against FITCO's directors and executive officers in the California Superior Court, alleging that they were negligent and breached their fiduciary duties. In addition, SBD has referred the FITCO matter to the local district attorney for criminal investigation.

V. FITCO -- LIQUIDATION.

Having closed FITCO, SBD is now liquidating it pursuant to the California Banking Law. Cal. Fin. C. Sections 3100 *et seq*. The problems that SBD has encountered and is still attempting to resolve in the liquidation are largely student loan problems. Therefore, I believe a brief status report on the liquidation would be helpful to the Subcommittee.

At the time of the closing, FITCO had a total of 2,400 trust and other fiduciary accounts, and the assets in the fiduciary accounts (the "fiduciary assets") had a total book value of $67 million. These totals included 1,500 trust rate accounts with book value assets of $30 million.

Also, at the time of closing, according to FITCO's books after SBD's examination adjustments, FITCO's own assets (the "corporate assets") totaled $7.9 million, and FITCO's own liabilities (the "corporate liabilities") totaled $8.4 million. Thus, FITCO had a deficit net worth of $500,000.

The liquidation of the corporate assets is now largely complete. In the process of the liquidation, it turned out that some corporate assets were worth less than book value, and some corporate liabilities exceeded book amounts. As a result, the deficit net worth has grown larger. Except for whatever may be recovered in litigation, the securities that FITCO deposited with the California State Treasurer as security for the faithful performance of its fiduciary accounts, and some equipment, the corporate assets have been virtually exhausted, and the liquidation operation is being funded by SBD.

In conjunction with the closing of FITCO, SBD undertook an effort to transfer the administration of FITCO's fiduciary accounts to other institutions. The effort was at least partially successful. FITCO's fiduciary accounts were divided into three categories, as follows: (1) conventional accounts (for example, guardianships, individual retirement accounts, Keogh accounts, and employee benefit accounts) that had no involvement with trust rate accounts ("purely conventional accounts"); (ii) conventional accounts that had some or all of their assets invested in trust rate accounts (the "mixed accounts"); and (iii) the trust rate accounts. On May 26, 1989, one week after the closing of FITCO, SBD with the approval of the California Superior Court transferred to a California state-chartered commercial bank all the 418 purely conventional accounts with book value assets of $21 million. About one month later, on June 30, 1989, SBD with the approval of the California Superior Court transferred to a California state-chartered trust company the conventional portions of 350 mixed accounts with book value assets of $14 million.

No institution in California could be found to take over substantial blocks or all of the remaining mixed accounts. Therefore, the trustors and beneficiaries of the remaining mixed accounts were requested to designate successor trustees for the conventional portions of their accounts, and the conventional portions of the accounts were transferred, one by one, to the successor trustees thus designated or, in the absence of any designation, the accounts were closed. The trust rate accounts were retained in the liquidation.

All the purely conventional fiduciary accounts and the conventional portions of all the mixed accounts, then, have been transferred out, and the only fiduciary accounts that remain are the trust rate accounts.

SBD's objective is to liquidate the assets of the trust rate accounts and return the proceeds to the customers. The following are the principal problems that SBD has encountered in achieving the objective:

1. Origination Fees/ED.

   When a lender makes a so-called "Guaranteed Student Loan" or "Stafford Loan," it is supposed to deduct from the proceeds of the loan an amount equal to five percent of the loan and pay that amount as an origination fee to ED. Although FITCO deducted the money for origination fees, it failed to pay all the money to ED.

   ED filed a claim for $4.4 million in origination fees. That was the amount that CSAC had determined was owing in its last program review of FITCO. Alleging that FITCO originated student loans as trustee of the trust rate accounts, ED asserted that the trust rate accounts were liable for the claim together with FITCO itself (i.e., that the fiduciary assets were liable as well as the corporate assets). The primary risk was that, if the origination fees were not paid, student loans originated by FITCO might be treated as uninsured.

2. Guarantee Premiums.

   When a lender makes a student loan, it is supposed to deduct from the proceeds of the loan an amount up to three percent of the loan and pay that amount as a guarantee premium to the guarantee agency. Although FITCO deducted money for guarantee premiums, it did not pay over all the money to the guarantee agencies. Generally, if the guarantee premium on a loan is not paid, the guarantee agency will not treat the loan as guaranteed.

3. Cancellations and Refunds; ED Audit.

If a student to whom FITCO made a loan failed to show up for the course or dropped out before the end of the course, the school would either return FITCO's loan disbursement check uncashed (a "cancellation") or write its own check to FITCO for the appropriate amount of reimbursement (a "refund"). If FITCO had sold the loan to a secondary market institution, FITCO was supposed to forward the cancellation or refund money to the secondary market institution.

FITCO fell far behind in processing cancellations and refunds. Its bank accounts were not reconciled, and cancellation and refund money was not forwarded to the secondary market institutions.

ED made an audit of cancellations of certain types of loans originated by FITCO during certain periods of time. On the basis of the audit, ED calculated that FITCO's delays in processing cancellations had caused ED to pay IB&SAP of approximately $1.2 million on student loans that had already been canceled. In addition, ED wanted audits for the types of student loans and time periods not covered by its audit. ED filed a claim on the audit matter and, as in the case of the claim for origination fees, pressed the claim against the trust rate accounts as well as FITCO itself.

4. Second Disbursements.

Student loans are made in two or more installments, or disbursements. This procedure prevents the student from receiving the entire proceeds of the loan at once.

In the case of a large number of loans, FITCO sold the first disbursement to a secondary market institution but did not complete the sale of the second disbursement. When FITCO was closed, it held $8.3 million of second disbursements. ED took the position that, unless the second disbursements were joined with the matching first disbursements, they would not be insured.

5. Secondary Market Institutions.

FITCO typically sold loans shortly after they were made, and the buyers were usually secondary market institutions that specialize in purchasing and holding student loans. At the time when FITCO was closed, two secondary market institutions which had purchased loans from FITCO had not yet paid for their most recent purchases. According to FITCO's records, California Higher Education Loan Authority, Inc. ("CHELA") owed $2.3 million, and West Texas Higher Education Authority, Inc. ("West Texas") owed $648,000. In addition, virtually all of the secondary market institutions to which FITCO sold loans had complaints about such matters as FITCO's failure to pay origination fees and guarantee premiums and FITCO's failure to transmit cancellation and refund moneys.

6. HEAF.

HEAF guaranteed a large part of the student loans originated by FITCO. Of the second disbursements, 70 percent were guaranteed by HEAF; of the whole loans held by the trust rate accounts, 44 percent were guaranteed by HEAF.

HEAF's financial difficulties have been widely publicized and are already known to the Subcommittee. Obviously, if HEAF is unable to pay on its guarantees, the trust rate accounts will suffer large losses.

In addition, SBD has encountered serious problems with HEAF. For example, HEAF has required that claims for payment under its guarantee of student loans originated by FITCO be accompanied by extended documentation, and the task of searching out and producing the extended documentation has placed a large burden on the liquidation. Moreover, HEAF has refused to follow rulings made by ED. For example, ED ruled that, in a case where the first and second disbursements of a student loan are combined, the loan need not be "cured" if one of the disbursements was serviced properly, provided that a new disclosure statement showing the total debt is sent to the borrower. Notwithstanding this ruling by ED, HEAF has taken the position that, in a case where the first and second disbursements of a student loan are combined, if there has been a so-called "due diligence violation" in the servicing of the second disbursement, the entire loan must be cured, even if the first disbursement has been properly serviced. This ruling poses a threat of substantial loss to the trust rate accounts.

SBD has been working diligently on all these problems. Some have been resolved, but many are still outstanding. The following is a summary of where things stand at present:

1. Second Disbursements.

In order to protect the guaranteed status of the second disbursements, it was necessary to join them with the matching first disbursements. CSLFC held first disbursements matching the bulk of the second disbursements, $8.1 million. After negotiations involving CSLFC, Bank of America, which serves as trustee under CSLFC's bond indentures, and the banks that issued letters of credit to back CSLFC's bonds, agreement was reached on a sale. The definitive contracts were signed and the sale was made on October 10, 1989, subject to approval of the California Superior Court. Court approval was obtained on March 20, 1990.

SBD has reached agreement to sell the remaining $200,000 of the second disbursements to CHELA.

2. Origination Fees/ED.

ED asserted its origination fee claim and audit claim not only against FITCO itself but also against the trust rate accounts. Even if ED did not have direct claims against the trust rate accounts, the claims represented a serious threat to the trust rate accounts. If the origination fees were not paid, the insurance of student loans originated by FITCO might be terminated. That would have a devastating impact on the loans held in the trust rate accounts, reducing them to a fraction of their value. It would have a similar impact on FITCO-originated loans held by secondary market institutions, and they would presumably seek reimbursement for their losses from the trust rate accounts. Thus, cancellation of the insurance would be a disaster for the trust rate accounts. The additional exposure resulting from the audit by ED and the further audits proposed by ED would only compound the disaster.

SBD felt it was imperative to contain this risk in order to protect the trust rate accounts. Therefore, it entered into settlement negotiations with ED. In January 1990, SBD agreed with ED to settle ED's claims for $4.4 million. The settlement with ED, like the other settlements made by SBD, is subject to approval of the California Superior Court.

To raise the $4.4 million, SBD proposed that each holder of student loans originated by FITCO on which origination fees were unpaid, pay its proportional share. In addition to the trust rate accounts, five secondary market institutions hold loans originated by FITCO on which origination fees were unpaid. Three of the secondary market institutions paid their shares in July 1990, as follows: West Texas, $467,000; CHELA, $361,000; and Western Loan Marketing Association ("Willie Mae"), $143,000. The two secondary market institutions that have not yet paid their shares are CSLFC, which has the largest share at $3.1 million, and Bank One, Merrillville, N.A. ("Bank One"), which has the smallest share at $17,000. Also, the trust rate accounts still have to pay their share of $338,000.

3. Guarantee Premiums.

To preserve the guaranteed status of student loans in the trust rate accounts on which guarantee premiums were unpaid, SBD paid the guarantee premiums.

4. Cancellations and Refunds.

SBD reconciled FITCO's bank accounts and identified the cancellations and refunds on student loans. The cancellations and refunds on the fiduciary side total $5.7 million, and there are sufficient funds on the fiduciary side to pay them. The cancellations and refunds on the corporate side total $3 million, but the cancellation and refund moneys on the corporate side are only $800,000. Thus, there is a shortage on the corporate side of $2.2 million.

Subject to approval of the California Superior Court, SBD made a proposal to the holders of canceled and refunded loans. The proposal was (1) to pay out the cancellation and refund moneys held on the fiduciary side to the holders of the canceled and refunded loans to which the fiduciary moneys relate, thus paying off those holders in full, and (ii) to pay out the cancellation and refund moneys on the corporate side to the holders of the canceled and refunded loans to which those moneys relate, thus paying those holders on a pro rata basis.

In May 1990, SBD sent lists of the cancellations and refunds to the holders of the loans affected.

Subsequently, a further complication developed. Apparently, while FITCO was still operating, it sent $1.5 million in refunds to CSLFC, asking CSLFC to check and see whether it owned the affected loans. According to SBD's findings, CSLFC is entitled to $922,000 of the refund money, but the remaining $612,000 belongs to others. CSLFC is unwilling to return any of the refund money.

5. Secondary Markets.

There are disputes with virtually all of the secondary institutions to which FITCO sold student loans. SBD is attempting to resolve the disputes through settlements.

SBD has reached settlements with West Texas and CHELA. SBD claimed that West Texas and CHELA still owed for loans it had purchased from FITCO. Also, SBD wanted West Texas and CHELA to pay their shares of the $4.4 million settlement with ED. West Texas and CHELA, on the other hand, claimed that they should be reimbursed for whatever they paid on account of origination fees. In addition, they demanded reimbursement for several other items, including payment of guarantee premiums, losses on cancellation and refund moneys, defects in loans purchased from FITCO, and administrative and legal expenses. Under the settlements, West Texas and CHELA paid their shares of the settlement with ED, and they are also to pay part of the unpaid purchase prices for their student loans.

SBD has also reached a settlement with CSLFC. CSLFC made claims similar to those asserted by West Texas and CHELA.

The settlements with West Texas, CHELA, and CSLFC, if consummated, will result in a loss of $2.3 million to the trust rate accounts.

Settlement negotiations with Willie Mae and Bank One are still in progress.

6. HEAF.

Although SBD has attempted to resolve the problems with HEAF, there has been little progress, and the problems for the most part remain outstanding.

As SBD understands it, HEAF is engaged in a dispute with CSLFC, Bank of America, and CSLFC's letter-of-credit banks. The dispute involves up to $400 million in loans and thus is more than ten times larger than the total holdings of the trust rate accounts. Some of the issues in this dispute relate to issues in SBD's dispute with HEAF, and SBD is concerned that the dispute between HEAF and SBD will not be resolved unless and until the other dispute is resolved.

Also, SBD is obviously concerned about HEAF's financial condition.

After adjusting for the losses and estimated losses determined to date in the student loans held for the trust rate accounts and after also adjusting for the losses involved in the settlements with West Texas, CHELA, and CSLFC, it appears that the trust rate accounts have thus far suffered losses of $5.1 million against total assets of $33 million. Additional losses are anticipated, but the amounts cannot be estimated at this time.

VI. CONCLUSION AND RECOMMENDATION.

As I indicated at the beginning of my testimony, I have not yet conducted a comprehensive and detailed review of the FITCO case. Therefore, it would be premature for me to draw definitive conclusions at this time. However, on the basis of the limited review that I have made, I would like to bring one matter to the Subcommittee's attention, and that is communication between the regulators of financial institutions and the government agencies that administer programs in which those financial institutions participate.

Over the years SBD has had good communication with the federal bank regulatory agencies; namely, the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Office of Comptroller of the Currency. Thus, reports of examination and other information concerning institutions under common jurisdiction are routinely exchanged, and SBD works in cooperation with the appropriate federal bank regulatory agency in addressing and correcting problems in the institutions regulated.

However, the lines of communication between the bank regulatory agencies and the government agencies that administer programs in which regulated financial institutions participate, has apparently not been as good as the communications among the bank regulatory agencies themselves. In the FITCO case, FITCO was a major participant in the student loan program, which is administered by ED and also by CSAC, HEAF, and the other guarantee agencies. SBD, as the regulator of FITCO, had some contact with ED and CSAC. In retrospect, without trying to place fault or blame on any party but rather in an attempt to identify what can be improved in the future, I believe that SBD's communication with ED, CSAC, and the other guarantee agencies could have been better. For example, SBD did not have immediate and direct information on the program reviews that CSAC made of FITCO, except for the last such review. Also, SBD was not informed that ED had objected to FITCO's deferring payment of origination fees.

SBD has already taken action to communicate more efficiently with government agencies that administer programs in which SBD's licensees participate. For example, SBD recently encountered difficulties with a state-chartered commercial bank holding loans involved in a program administered by the U.S. Department of

Housing and Urban Development ("HUD"). SBD met with HUD to obtain information on the program. HUD was very helpful; and, as a result, SBD was better able to evaluate the loans, determine the effect of the loans on the bank's condition, and take appropriate action.

As I understand it, communication between the regulators of financial institutions and the government agencies that administer programs in which those financial institutions participate may in some measure be impeded by statutes that restrict government agencies in providing confidential information to other agencies. In California, the Legislature recently amended the state laws to facilitate the exchange of information among regulators of financial institutions. Perhaps, similar changes should be made at both the state and federal levels to facilitate the exchange of information between agencies that regulate financial institutions and agencies that administer programs in which the financial institutions participate, and I would respectfully suggest that the Subcommittee consider such changes.

ANSWERS OF JAMES E. GILLERAN, SUPERINTENDENT OF BANKS OF STATE OF CALIFORNIA, TO FOLLOW-UP QUESTIONS OF PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF U.S. SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

November 8, 1990

1. Q. Were the California State Banking Department ("SBD") examiners sufficiently familiar with the legal and regulatory requirements of the Federal guaranteed student loan program when they reviewed First Independent Trust Company ("FITCO")?

A. SBD's examiners had a basic knowledge of the student loan program. However, they did not profess to be experts on student loans.

SBD's examiners consulted at times with the California Student Aid Commission ("CSAC"). Also, FITCO's student loan operations were reviewed by CSAC and by the Higher Education Assistance Foundation ("HEAF"). CSAC and HEAF were, of course, experts on student loans.

Considering these circumstances, I believe that SBD's examiners were sufficiently familiar with the student loan program.

2. Q. Did SBD rely on information and advice from the U.S. Department of Education ("ED") and CSAC regarding decisions made about FITCO's participation?

A. In a letter to FITCO dated January 9, 1986, SBD questioned whether FITCO qualified as an eligible lender under the Higher Education Act of 1965. For FITCO to be an eligible lender pursuant to the relevant provisions of Section 435(d) of the Act as in effect at that time, it was required that FITCO be a state chartered bank and that the making of student loans not be its primary consumer credit function.

Subsequently, SBD was informed that both ED and CSAC considered FITCO qualified as an eligible lender. Eventually, the Act was amended to eliminate the bases for the question that SBD had raised.

3. Q. Are all commercial banks in California required to participate in a Federal deposit insurance program?

A. SBD's regulations require that a California state commercial bank obtain FDIC insurance before commencing business. 10 California Code of Regulations Section 10.3520.

4. Q. Why not FITCO and other trust companies?

A. California state commercial banks are authorized to accept deposits in the general sense of the term (i.e., deposits that give rise to a creditor/debtor relations). California Financial Code Sections 102 and 105. California state trust companies, on the other hand, may not take deposits except deposits accepted in a fiduciary or other representative capacity and deposits accepted from a court-appointed fiduciary under court order. California Financial Code Sections 106, 1580, and 1586. Since the authority of trust companies to accept deposits is so limited, trust companies are not required to be insured by the FDIC. Indeed, an institution that receives only trust funds on deposit is not eligible to be insured by the FDIC under federal law. Federal Deposit Insurance Act Section 8(p); 12 U.S.C. Section 1818(p).

5. Q. Did SBD, prior to the seizure of FITCO, ever take any civil or criminal action against FITCO?

A. SBD did not, before closing FITCO, initiate any civil or criminal action in the courts against FITCO. However, as outlined in my written statement, SBD did take various administrative actions in attempting to resolve the problems at FITCO. The administrative actions included making examinations and visitations as well as holding meetings with FITCO and its attorneys and corresponding with them. Ultimately, SBD aimed to have FITCO enter into a written agreement spelling out rules for its administration of the trust rate accounts and other matters, but the terms of such an agreement were still at issue when FITCO was closed.

Since the closing, as Liquidator of FITCO, I have commenced a civil action against certain former directors and officers of FITCO. Also, the FITCO matter has been referred to the local district attorney, and his office is conducting a criminal investigation.

6. Q. A review of records supplied to the Subcommittee by SBD suggests that FITCO constantly evaded the central regulatory issues raised by SBD, never coming up to the scope of the problems. It appears that SBD bent over backwards to get FITCO to fall into line, but to no avail. The same adverse findings were made year after year. Why didn't SBD cease FITCO's operations earlier?

A. It is true that SBD identified deficiencies in its examinations of FITCO. However, while the deficiencies were significant, they were not regarded by SBD as being so serious as to require the closing of FITCO.

SBD attempted to correct the deficiencies at FITCO. SBD's efforts were successful in some respects, and FITCO did make some improvements. However, FITCO failed to set all the deficiencies straight. Also, in some cases where FITCO made corrections, it was unable to sustain the corrections and lapsed back into its deficient ways. In the end, when FITCO's capital was exhausted, it was closed.

During the examination that commenced on April 13, 1989, SBD found that tangible shareholders' equity, after taking SBD's adjustments into account, was in a deficit position. On May 4, 1989, SBD notified FITCO that it would have to replenish its shareholders' equity in three installments, with the first installment due by May 11, 1989. When FITCO failed to make the first installment, SBD took possession of FITCO on May 19, 1989.

7. Q. Did SBD adequately protect the citizens and companies that entrusted their money to FITCO for investment?

A. Thus far, I have not seen anything to show that SBD's performance did not measure up to the standards expected of a regulatory agency.

As I explained in my written statement, FITCO was closed almost two months before I took office as Superintendent of Banks. Since the closing, SBD's available resources have been concentrated on liquidating FITCO and preserving the assets of the trust rate accounts for the benefit of the customers. Once resources can be diverted from the liquidation, I plan to make a more comprehensive review of the FITCO case.

8. Q. What did you know about FITCO's parent organization, Lawyers Financial Corporation ("LFC")? Was LFC regulated by the State of California?

A. It was LFC that applied to SBD in 1974 for authority to organize FITCO, and information about LFC was furnished to SBD in connection with the application. According to that information, LFC was a California corporation which had been incorporated in 1960. At one time, LFC had registered as a savings and loan holding company with the State of California and held an interest in Loyalty Savings and Loan Association. In 1973, the year before the filing of the application, LFC, as part of the settlement of a lawsuit, sold its interest in the savings and loan association.

Under the California Banking Law, a company that controls a California state commercial bank or trust company is subject to examination by SBD but is not regulated by SBD. California Financial Code Sections 3700 et seq. SBD made a limited examination of LFC in 1980.

In the course of its examinations of FITCO, SBD usually obtained information regarding LFC, such as financial statements. However, beginning with the examination of November 17, 1986, FITCO informed SBD's examiners that the records relating to LFC could not be located. Although the absence of the records was a matter of concern, it was not viewed as critical because SBD was not at that time looking to LFC as a source of capital support for FITCO.

So far as SBD is aware, LFC is not regulated by the State of California.

9. Q. Former FITCO employee, Terry Sandoval Robertson, made serious allegations about FITCO in 1986. Was SBD made aware of these allegations? Did SBD interview Ms. Robertson? Did SBD take any actions based on her allegations?

A. SBD became aware of Theresa L. Sandoval's allegations of irregularities at FITCO through a letter dated October 16, 1986 from Carolyn A. Pacheco, attorney for Ms. Sandoval, to FITCO.

Robert F. Tyler, who was then a Supervising Deputy Attorney General of the State of California representing SBD, contacted Ms. Pacheco to make arrangements to interview Ms. Sandoval. Ms. Pacheco, however, refused to make Ms. Sandoval available to Mr. Tyler on the grounds that Ms. Sandoval was prevented from speaking to Mr. Tyler by a restraining order entered in a suit brought by FITCO against Ms. Sandoval in which FITCO alleged that she had improperly acquired FITCO documents.

SBD investigated the allegations of irregularities in Ms. Pacheco's letter during the examination of FITCO that commenced on November 17, 1986.

Also, Mr. Tyler took additional follow-up action on behalf of SBD. He had four telephone conversations with Ms. Pacheco and two telephone conversations with Ms. Pacheco's successor as attorney for Ms. Sandoval, Douglas Sears. Also, Mr. Tyler contacted four former employees of FITCO who, Ms. Pacheco asserted, could corroborate Ms. Sandoval's allegations against FITCO. In addition, Mr. Tyler had conversations with ED and the office of the local U.S. Attorney about the Sandoval matter.

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September 20, 1990

Senator Nunn, your letter to me requested I comment on a number of items. Each in itself is an involved subject. I will touch on each briefly.

In August 1974 I went to work for the Office of Guaranteed Student Loans in Region IX, San Francisco, CA. as a program officer. We were responsible for monitoring the loan program in the states of Arizona, California, Hawaii, Nevada and the Trust Territories. Nevada was the only state with a guarantee agency; the other states used the Federal Insured Student Loan Program.

Our staff consisted of a supervisor and four program officers. We issued commitments for loans, answered questions regarding the program from students, lenders and schools and had the responsibility for monitoring the compliance of at least 800 lenders and half that many schools. When I retired at the end of 1988 Region IX had expanded to 14 states and we had a supervisor and five program officers. We had been relieved of the responsibility of monitoring schools along with the issuance of commitment and answering general information questions.

Two things had a great impact on our ability to perform our mission. One was staff training and the other the availability of travel funds. My training in 1974 consisted of being given an outdated manuel, a set of regulations and being taken on two program reviews, one of a school and the other a lender. Over the years training was a hit or miss proposition. In the mid 1980s Washington began to put training programs together which were helpful and enabled us to do a better job.

The other item I mentioned was travel. There were periods where there was no money for this. Without travel funds we could not make reviews of lenders or guarantee agencies and hence were unable to do our job. What funds were available appeared to be directed to the campus based programs. 'This lack of funds did not permit us to use the training we received. Had we been able to travel some of the abuses we now see might have been curtailed. Often we traveled for the purpose of putting out fires.

One further point. Between 1974 and 1988 the loan program changed significantly. First, loan volume expanded dramatically; the Federal Insured Student Loan Program was phased out and the guarantee agencies took over; out of state lenders moved into

Region IX; community college and propriatory students began to get access to loan funds in the early 1980s.

Region IX always had a close working relationship with the guaranty agencies. With both the California Student Aid Commission and United Student Aid Funds we assisted in the training of their review staffs by conducting joint reviews with them, exchanging travel plans and sharing our review findings.

This free exchange of information did not take place with other regulators whether it be federal or state with one exception. This is a serious deficiency which should be examined and corrected.

The First Independent Trust Company (FITCO) first came to my attention in 1980 when they became a lender with the California Student Aid Commission (CSAC). In 1981 two of us visited FITCO for the purpose of making a program review; our primary objective was to examine the interest and special allowance billing being submitted to the Department of Education (ED). As I remember there were no particlar problems in that area. Loan volume at FITCO was small at that time. Our primary concern was staffing. We told management that there was no way two people could handle the work load. At the time most of the loans were to students still in school or their grace periods; however, once they went into repayment additional staff would have to be allocated in order to do the necessary due dilligence.

From this point on we had regular contact with FITCO management. Generally, it related to the difficulties they were having in increasing their percentage of the student loan market. They often asked our opinion on various marketing programs. In one paricular instance we felt their plan would be an inducement an therefore, a violation of the regulations.

In late 1985 we first had a clue that there might be a problem at FITCO. During a visit to United Education and Softfware (UES) for another purpose it came to our attention FITCO was not forwarding cancellations and refunds to UES promptly; delays as long as 14 months were noted. This matter was brought to FITCO management's attention and they placed the blame on UES.

UES provided me with a printout showing there were in excess of 15,000 of these late items. My sampling indicated the loan holders had been paid in excess of $2,000,000 in interest and special allowance because of these delays. FITCO management disputed this, blamed the delays on UES and promised to look into the matter.

At this point in time we were without travel funds; also my staff was down to three program officers. As a result I felt we were unable to take on a project of this magnitude. The information was given to ED's Inspector General for Audit, Region IX. After their audit it was determined FITCO owed over $1,100,000 in interest and special allowance to ED.

During this period we did have one meeting in Sacramento with the State Department of Banking regarding FITCO. The concerns were that the liability mentioned above would put FITCO in a deficit net worth position. No firm conclusions were made. After this we did have occassional contact with the Banking Department. Also present at the meeting were representatives from CSAC and the Inspector General.

In late 1987 CSAC advised Region IX they were going to do a program review of FITCO in January of 1988. To assist CSAC we ordered printouts of interest and special allowance payments made to FITCO. From these we determined FITCO had not filed reports in over one year. ED did not have a program at the time to monitor lenders who failed to file interest and special allowance reports. Two of us joined the CSAC staff to participate in the interest and special allowance portion of the review. While on site it was estimated FITCO owed ED over $10,000,000 in origination fees over and above the interest and special allowance due them. FITCO was advised these reports had to be filed immediately and all fees paid. Over the next six months they filed all 1987 reports and paid ED approximately $13,300,000 in origination fees. In July 1988 the UES problem arose and the pressure on FITCO was relaxed because of our limited resources. The first two 1988 quarterly reports were not filed until 1989; however, the origination fees were never paid and are still due.

The California Student Loan Finance Corporation (CSLFC) as a secondary market, began purchasing loans in 1981 or 1982. Under the statutes they were not an eligible lender for the Guaranteed Student Loan Program. The lender of record for the loans they held was the Bank of America, Trustee. All payments by ED were made to the Bank; they were the responsible lender.

CSLFC marketed their program very aggresively and purchased loans the other secondary market put restrictions on. As a result propriatory schools sought out lenders who would sell to CSLFC. Over a period of time FITCO became the largest lender in California and prime source of CSLFC's purchases. As FITCO became a national lender CSLFC began to purchase loans for students attending schools throughout the United States.

The CSLFC loan portfolio was not reviewed by ED for various reasons. We had been told by ED in Washington to not review servicers as we had no legal authority to do so; they were not a participant in the program. Also, staff limitations and minimal travel funds limited what we were able to do.

ED generated computer analysis of interest and special allowance billing. In approximately 1985 or 86 we noted ED had overpaid the

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Bank of America, Trustee about $400,000 in interest and special allowance on behalf of CSLFC. It was refunded and we received a certification that other quarterly billings have been examined and this was an isolated error. Region IX did not have the opportunity to actually verify this.

As time proved, the lender of record, Bank of America, Trustee was not monitoring what CSLFC was doing and being sure CSLFC was in conformance with the statutes and rules and regulations of the Guaranteed Student Loan Program.

UES/CSLFC have to be looked at as one entity. It was difficult to determine where one took over and the other left off. When there was a question either could be contacted for an answer. If you called the lender of record, Bank of America, Trustee, they would refer you to CSLFC.

UES had owned and operated schools for a number of years. They also had a servicing arm which serviced National Direct Student Loans for schools. From this they expanded into the servicing of Guaranteed Student Loans in about 1982 or 83. Initially it was a small operation. However, the success of CSLFC's marketing program caused it to grow rapidly. They were unable to absorb this growth in an orderly fashion.

From around 1986 on we began to receive a few complaints regarding the loan servicing at UES. As we were not the loan guarantors the majority of such complaints went to CSAC and the other guarantors. CSAC and Region IX did discuss the problems.

Both of us brought these concerns to the attention of the managements of UES and CSLFC. In all cases the individual problems were resolved. We were assured that with new computer equipment and new larger facilities these problems would soon be resolved. As we were to determine in 1988 this was not the case.

A review in June of 1988 indicated the situation at UES was out of control. There were literally hundreds of boxes of unfiled correspondence dating back many months. As a result students were being deprived of the rights provided them by the program and due dilligence was not being performed on the loans. There was also a concern that collection records were being falsified. For example, collection histories indicated final demand letters were sent on a specific date; investigation showed they were never sent. Collection histories showed long distance telephone calls were made but examination of telephone records did not substantiate this. A joint review team from two guarantors and ED visited UES the last week of July 1988 and verified the above. This resulted in ED refusing to reinsure all loans serviced at UES.

You requested I comment on the relationship between headquarters and the regional office. As I mentioned earlier the emphasis in my first years was on the campus based programs. The student loan program was not the number one priority. The headquarters staff was always very hard to reach for advice and guidance. I feel this was due to the demands being made upon their time not due to any indifference. When the Office of Student Financial Assistance was reorganized in around 1986 the situation improved greatly. Answers and guidance were much more easily available.

I appreciate this opportunity to have expressed my thoughts. Due to time limitations I have only touched on some of the problems. If you have any questions I will be pleased to respond.

John H. Keefe

RESPONSES TO FOLLOW-UP QUESTIONS

JOHN H. KEEFE
Former Employee, U.S. Department of Education

Question: What did you know about FITCO's parent organization, the Lawyer's Financial Corporation? Was this corporation regulated by the State?

> Answer: We knew nothing of FITCO's parent organization, Lawyer's Financial Corporation. Our interest was in FITCO's student loan operation; other regulators reviewed this area. I do not know if this corporation was regulated by the state but assume it was.

Question: Former FITCO employee, Terry Sandoval Robertson, made serious allegations about FITCO in 1986. Was the State Banking Department made aware of these allegations? Did your agency interview this woman? Did your agency take any actions based on her allegations?

> Answer: I do not know if the State Banking Department was made aware of Ms. Sandoval's allegations. We did not interview this woman as we were unaware of the incident at the time.

Question: Isn't it true that FITCO was doing the majority, if not almost all, of its consumer credit function in student loans? Prior to 1986, weren't eligible lenders prohibited by law from doing that?

Secondly, prior to 1986, the statute defining eligible lenders included only "national or State chartered bank, a mutual savings bank, a savings and loan association or a credit union." As a trust company, how could FITCO be an eligible lender?

> Answer: Almost all of FITCO's consumer credit function was in student loans. This situation was discussed by the California Student Aid Commission (CSAC) and ourselves and we felt this was permissible as FITCO was neither a bank nor S & L.
>
> FITCO applied to CSAC to become an eligible lender in approximately 1980. Region IX was not involved in the process. My understanding is our Central Office concurred with CSAC that FITCO met the requirements of an eligible lender.

Question: Your office at the Department of Education was responsible for oversight at FITCO and UES, among other lenders and servicers in the area. Recent post-liquidation reviews of FITCO and UES have revealed startling violations of law and regulation pertaining to the student loan program. How did these violations go unchecked?

> Answer: The early reviews of FITCO, when loan volume was nominal, did not reveal startling violations. Violations were first noted in a CSAC review in around 1987. At that time efforts were made to bring FITCO into compliance; our policy was to allow any institution, lender or school, the opportunity to correct their deficiencies.
>
> UES was a somewhat different situation. As mentioned in my testimony we were told to not review servicers as we had no authority to do so.

Question: The Higher Education Act prohibits correspondence schools from originating guaranteed student loans to its student. However, it appears that UES was able to sidestep this prohibition by entering into an agreement with FITCO to originate loans on FITCO's behalf to UES correspondence school students.

On August 16, 1984, you wrote to Aaron Cohen concerning the processing of loans to UES students. In that letter, you stated that as long as there was no processing on UES's part, there would not be any origination conflict.

Then, on November 26, 1986, Aaron Cohen wrote you a letter which served as a written confirmation of a telephone conversation he had had with you on that date. In his letter, Mr. Cohen writes, and you concur through your signature, that you had told him that the Higher Education Reauthorization Act of 1986 allowed UES to service all aspects of the processing and administration of student loans to students in UES owned schools. Did you approve of this practice? Didn't this practice smack of a violation of the spirit of the law?

> Answer: Included in the origination process of loans is the approval of the loans. While UES did the paperwork part of the origination final approval of the loan remained with FITCO; this approval was accomplished by their signing of the disbursement check.
>
> We did approve of this practice because final approval remained with FITCO. My own feeling is this did not "smack of a violation of the spirit of the law" because the process conformed to the regulations. Our mission was to apply the regulations not to interpret them.

Question: How long have you been familiar with FITCO? Would you say FITCO was ever a sound financial institution? If no, why continue to allow them in Federal loan program?

> **Answer:** I first became familiar with FITCO in 1980 or 1981. As mentioned earlier we only reviewed the student loan function of an institution. We did not have the expertise to evaluate the financial condition of a lender; this was left to other regulators. They were allowed to continue as we were unaware of their financial situation.

Question: When were you aware FITCO was not paying its origination fees? How did it continue to file in an untimely manner, its 799's, even after the Department knew of the problems?

> **Answer:** We were first aware origination fees were not being paid in approximately December 1987. At that time, ED did not have a program in place to monitor lenders who failed to file 799s; further, the 799 process was handled through the Central Office not the region. FITCO's situation was unique as most lenders were due money from ED and therefore, they filed their 799s in a timely fashion so as to get paid. FITCO was the first institution to continually have origination fees that exceeded the interest and special allowance due them.
>
> After we determined this, Region IX brought the situation to the attention of the Central Office. Further, between January and July 1988, Region IX saw to it FITCO filed their 1987 799s and paid in excess of $13 million in origination fees. After the UES situation surfaced in mid-1988, staff limitations caused us to take the pressure off FITCO.

Question: Given FITCO's status as a top-volume lender of loans in the country, as well as the apparent financial problems that existed, why did the Department conduct so few reviews?

> **Answer:** Through approximately 1984, FITCO was not a top volume lender. Only when they began to use the Higher Education Assistance Foundation as a guarantor did they become a high volume, national lender. Early program reviews did not indicate any significant problems and therefore, there was no need to accelerate the review process. Also, due to staff limitations and lack of travel funds, there were years we conducted a minimal number of reviews. Due to our not looking at the financial condition of lenders we were unaware of the financial problems.

Question: To your knowledge, has the idea of administrative penalties charged to lenders been discussed at the Department? Why are no such penalties levied?

> Answer: I am not aware whether the idea of administrative penalties was discussed at the Central Office level. If my memory serves me right, we did not have the authority to levy such penalties in those years.

Question: When you made findings at FITCO in your reviews, what was the attitude of FITCO officials toward making these changes?

> Answer: FITCO officials were always receptive to making any changes suggested. However, these promises of change were not always made. An example of their cooperation was the filing of delinquent 799s in early 1988 after we discovered the problem.

Question: The Department required FITCO to bill schools for in-house computers because it considered providing these computers an inducement. Did FITCO ever collect these fees?

> Answer: FITCO did bill many schools for the use of in-house computers. Some schools did pay. If I remember correctly, this issue is addressed in a CSAC program review.

Question: Did you have a responsibility to oversee UES servicing operations?

> Answer: As previously noted, Central Office advised we had no authority to oversee servicers.

Question: Did you ever review the secondary market doing business with FITCO?

> Answer: Because of staff limitations and lack of travel funds, Region IX never made a review of the secondary market doing business with FITCO. We did from time to time review their 799s. On one occasion we required the secondary market to repay ED approximately $400,000 because of an overbilling on interest and special allowance.

Question: When reviewing a lender, does the Department ever seek information from any banking regulators concerning that institution?

> Answer: We never contacted another regulator prior to making a review. Even when we were on site at the same time as other regulators, we did not exchange information. Because of confidentiality problems other agencies were reluctant to share findings.

Question: Do you review findings of guarantee agencies prior to reviewing lenders?

> Answer: We always reviewed guarantee agency findings prior to making a program review. Region IX and CSAC always exchanged copies of our reviews. The problem was Central Office required we sanitize our reviews of all names and social security numbers because of confidentiality. As a result, I feel the value of our reviews to the agency was diminished.

September 20, 1990

Honorable Sam Nunn, Chairman
Permanent Subcommittee on Investigations
100 Russell Senate Office Building
Washington, D.C. 20510

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss First Independent Trust Company's (FITCO) participation in the Federal Guaranteed Student Loan Programs. My name is Deno Evangelista and I am Founder, President and Chairman of the Board of FITCO. I understand that today's hearing will include discussion relating to lenders, guarantors, the secondary market, and student loan servicers. I will focus my testimony on these business organizations in that sequence.

I believe, however, that I should first tell you something about my background. My introduction to America was an experience on Ellis Island as an eight year old boy in December 1929 and from there to Morgan, Pennsylvania, a mining camp of 350 people. It was here where I learned that Tennessee Ernie Ford's song "Sixteen Tons" was a fact--a coal miner truly owed his soul to the company store. It was from this background that I realized the importance of getting an education.

My professional career has been spent in all aspects of finance. I have appeared as an expert witness in the courts regarding financial matters and, at one time, as a member of the Sacramento Chamber of Commerce, was the most requested speaker on financial matters. I have appeared on radio and television and contributed substantially in revising and amending California law in the areas of banking, insurance, and real estate.

Your staff has indicated that my appearance before you should include a brief history of FITCO. In the latter part of 1972, I prepared an application to the California State Banking Department (Banking Department) for authorization to engage in the commercial banking business in the City of Sacramento. The application was not formally submitted because, after three personal meetings, the Banking Department's negative position was clear: "there is a Bank of America or Crocker branch on every corner of Sacramento." But there was no independent trust company in Northern California, and those larger institutions were not providing directory trust services for the ordinary citizen. Therefore, I prepared and submitted a formal application for FITCO to the Banking Department on December 28, 1973. After numerous meetings with the Superintendent of Banks and his deputies, the application was denied. After further protracted discussions, my attorneys finally filed suit against the Banking Department. On August 7, 1975, in accordance with a peremptory Writ of Mandamus issued by the Superior Court of the State of California for the County of Sacramento, the denial was set aside and the Banking Department was ordered to approve the application. A charter authorizing FITCO to enter into the trust banking business was issued and dated August 22, 1975.

I must point out, Mr. Chairman, the animosity that existed at that time and continued without abatement throughout the 15 year history of FITCO. The length of time in obtaining the trust company charter and the way it was obtained--by court order--from the very beginning created an adversarial relationship between myself and the Banking Department. Examinations were frequent, disruptive and argumentative and, after FITCO became involved in the student loan programs, special audits were made to disprove the student loan eligibility of FITCO. The increasing level of hostility forced management disruption exemplified by the resignation of a founding director. (See the attached letter of resignation of Chris Marelia, Exhibit A.) Other director resignations became a reality. The attached letters from two of my attorneys demonstrate the intensity of the Banking Department's efforts to destroy FITCO (see Exhibits B and C).

The most destructive argument that arose was the Banking Department's assertion that we were not an eligible lender--an allegation first made six years after FITCO first became involved in the student loan program, despite several interim examinations. The Banking Department's insistence led FITCO into another court action because the Banking Department refused to accept confirmation from the California Student Aid Commission (CSAC) and apparently did not even know (and may not even now know) the fact that various bond counsel and the Attorney General of the State of California had declared FITCO to be an eligible lender. (See Exhibits D and E.)

Mr. Chairman and Members of the Committee, let me assure you that the relationship was at the breaking point when the Banking Department apparently believed the false and outrageous claims made by certain guarantors against FITCO. I am referring to reports from CSAC and particularly from the Higher Education Assistance Foundation (HEAF). On May 19, 1989, the Banking Department administratively took possession of FITCO's business and property. The failure of the Banking Department to fully comprehend the complexity of the reconciliation procedures then in place and the student loan program in its totality, and setting aside all positive actions being taken by FITCO to resolve the financial crisis, resulted in the disaster that followed to the trust beneficiaries, the loss of 220 jobs, and destroyed California's leading lender's participation in the student loan program. The action taken by the Banking Department was arbitrary, capricious, and a gross abuse of discretion. The Banking Department has kept me in the dark since the above date.

How can the Banking Department reasonably rely on HEAF's claims against FITCO when the Department of Education's Inspector General's report of July 1988 found HEAF documentation records inadequate--a discrepancy of $127 million which HEAF settled with the Department of Education for $2,687,279? HEAF was, at that time, involved in a new financing that would have failed were they to disclose the contents of the Department of Education draft in the prospectus. The adverse disclosure would have terminated the financing. May I add, Mr. Chairman, that HEAF's financial problems were even then suspect because of our own dealings. They later became well known to me because during an attempted records reconciliation period my staff found that HEAF supplied FITCO with huge numbers of student loans that were not originated by FITCO.

As to CSAC, our payments to them of the insurance premiums used the same procedures for the payments as did other lenders participating in the program. I will state now, without equivocation, that CSAC's detailed accounting records for insurance premiums paid and rejected and their loan processing system experienced numerous integrity failures.

FITCO attempted to manifest a significant number of CLAS loans. After computer effort, we finally convinced CSAC that the fee paid and reported by FITCO was correct. Faced with the evidence from their own rejection report, CSAC had no option but to admit their system had incorrectly rejected loan disbursements. To this day, many thousands of dollars of unapplied insurance premiums paid by FITCO remain in CSAC's possession. The problem with CSAC will remain unresolved until someone gets, and may I respectfully request that you do ask for, the auditor's working papers. FITCO paid insurance premiums to CSAC, HEAF and other guarantors, but the Banking Department, in its rush to close FITCO down, failed to understand that the reconciliation system put into effect by FITCO would have resolved the disputed payments. After approximately 16 months, the Banking Department continues to attribute the failure of FITCO's student loan program on FITCO's management.

I appear in front of you today frustrated, for I cannot understand the continuing derogatory remarks concerning FITCO's takeover by the Banking Department because of a technical impairment of capital in the approximate sum of $93,000.

Mr. Chairman, FITCO, the largest student loan lender in California for the past three (3) years, as reflected in the United States General Accounting Office Report dated February 1990, Report #B327438, the largest Supplemental Loans for Student(s) Program (SLS) lender for the fiscal years 1987, 1988, 1989, FITCO made more than twice the loans made by CitiBank and Bank of America combined. It finds itself now out of the student loan business even though FITCO had time remaining to cure the capital impairment problem. In its rush to close down FITCO, the Banking Department even interfered with a planned shareholders meeting to discuss FITCO's financial condition.

My introduction and inquiry into the student loan programs was quite disappointing. The State of California was relying upon two large New York banks to supply the needed capital to educate the students of the largest and most prosperous state in the United States. I discovered that the eligible lenders in California and the secondary markets, including Sallie Mae, exercised what I call "mathematical bigotry." This is exemplified in the practices described in the attached letter to me from Webster Career College. (See Exhibit F.)

My first directive to my employees regarding the student loan program that we were about to enter was that loans would be made by FITCO to all eligible students who wanted to improve their standard of living by an education in the field of their choice, from barbers and beauticians to doctors and lawyers. Restrictions or discrimination would not be tolerated because I strongly felt that next to internal and external peace, nothing is more important for America than an education of its youth.

In 1981, FITCO entered into a contract with CSLFC which acted as a secondary market operation with Bank of America as trustee and as lender of record for the loans they acquired. The working relationship, from the beginning, always required some type of adjustment and reconciliation. The adjustments are routine acts between any eligible lender and any secondary market operation. We were comfortable with the operations and were not aware of the review made in early August 1988. I refer to a review conducted by the United States Department of Education, the Higher Education Assistance Foundation, and the California Student Aid Commission, dated August 25, 1988, revealing serious loan servicing deficiencies and due diligence violations. May I add that this information was never made known to FITCO until 1989, at which time I wrote to the Secretary of Education urging his prompt resolution of the issues. (See Exhibits G and H). The failure of these parties to notify FITCO timely and responsibly caused FITCO eventually to take legal action against Bank of America and CSLFC.

Bank of America had purchased as trustee for the California Student Loan Finance Corporation (CSLFC) student loans for which Bank of America was the lender of record. Bank of America held the original notes and related documents and had paid FITCO for only one-half (1/2) of the face value of the insured student loan notes purchased. Bank of America was later furnished with the documentation reflecting that the student loans were fully dispersed and that Bank of America's payment for the remaining one-half (1/2) of the face value of approximately $12 million was past due and payable.

On April 13, 1989, I had a detailed telephone discussion with Mr. Richard Griffith, Executive Vice President of Bank of America relating to these student loans that Bank of America had purchased from FITCO. I demanded immediate reimbursement to which Mr. Griffith responded: "Deno, I'm going to tell you something, but if it ever gets to court I will deny it. If you want your money, sue the Letter of Credit Banks." He was referring, of course, to the nine largest banks in the world which had already filed suit against Bank of America.

Mr. Chairman, so far as I am aware, the Banking Department still has not collected in full the millions of dollars owed to FITCO by Bank of America?

This entire episode has been very trying for me, both personally and professionally. An institution serving the educational needs of thousands of disadvantaged citizens has been totally destroyed by the defaults of others compounded by malicious, uninformed and ill-advised regulators. Unfortunately, the final chapters in this saga will be written by the courts where I expect FITCO and its loyal officers and employees to be fully vindicated. I appreciate this Committee's thorough investigation of all the circumstances involved in this affair and I will be most happy now to answer any questions. Thank you.

Very truly yours,

Deno Evangelista

DENO EVANGELISTA

March 5, 1986

Mr. Deno Evangelista
Chairman of the Board
First Independent Trust Company
1020 12th Street
Sacramento, California 95814

Dear Deno,

After eleven continuous years of association with you in the organization and development of First Independent Trust Company as a viable and successful financial institution which has attained a position of eminence in our community. I regretfully now tender my resignation as a director effective March 18, 1986. You are certainly entitled to know why I have made this decision.

During my long tenure with the Company, in a number of executive positions, we have shared together many pleasures and disappointments, success and failures. I have always been proud of my association with First Independent Trust, its public acceptance, its relationship with our Courts, its devotion in providing a useful service to our citizens (especially the "little-man"), its participation (financial and otherwise) in community activities.

Of late however, our efforts to continue the important work upon which we are embarked has been frustrated by certain actions taken by the State Banking Department which I feel borders on harassment because according to many legal opinions, by our own counsel, co-counsel and outstanding attorneys who specialize in the field of banking and trust law, all confirm that in no way are we in violation of any existing law or governmental regulation.

As you know, I actively practiced law for over 25 years specialising in probate, trusts and estate planning. I helped organize and manage First Western Bank's Sacramento Trust Office. Later I was employed for a number of years as Vice President, Trust Officer and Manager of United California Bank's Sacramento Division. I feel I am in a position to fully comprehend in an unbiased and intelligent manner the adverse effect of the dispute between our Company and the State Banking Department.

Unless the disagreements between the Company and State Banking Department can be settled in a satisfactory manner by negotiation, the Company will be driven into a Court proceeding which will be time consuming and expensive. This situation needlessly consumes an inordinate amount of management time, frustrates the Company's orderly operation, development of its services and creates an internal atmosphere of uncertainty and futility. It has become a constant source of worry to me as a director and imposes responsibilities I no longer wish to assume. Other members of your Board share my feelings.

It is my fondest hope that when the final chapter is written our position in this matter will be sustained.

Sincerely,

Law Offices of
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February 17, 1986

Mr. Louis Carter
Superintendent of Banks
State Banking Department
1107 Ninth Street, Suite 360
Sacramento, California 95814

Re: First Independent Trust Company
(Bank Number 1136)

Dear Mr. Carter:

This letter is in response to the Department's letter of January 9, 1986, and addresses those matters discussed at our subsequent meeting with FITCO directors and Department staff on January 16.

Let me state at the outset that I make no apology for the sometimes blunt characterizations and comments made herein. Your staff has leveled a number of baseless charges of the most serious nature against FITCO and its operations that go to the very heart of its existence as a financial institution in this state. In my judgment, it has been done in a careless and cavalier fashion, with apparently little or no regard for the extraordinary effort required of FITCO to refute these charges. I very much regret the necessity of engaging in this kind of dialogue but I find the Department's analysis of the issues discussed in its January 9 letter to reflect a substantial misunderstanding both of the facts surrounding the issues and of applicable state and federal laws. These basic misunderstandings no doubt contribute to the conclusion therein that the condition of FITCO is "unsatisfactory" and "continues to deteriorate." We wholly reject that conclusion and, assuming it is based upon the misperceptions contained in the January 9 letter, there is no evidence whatsoever to support it.

The charges set forth in that letter are difficult to address in that it is not always clear just what has been alleged. One troublesome syllogism, discussed below, is the apparent claim that if FITCO's management of trust monies were to breach fiduciary duties it would become commercial banking by definition. This, of course, is nonsense. A trust relationship does not cease to be a trust due to the hypothetical--and erroneous--assertion that a breach of trust has occurred. Another anomaly is the claim that an institution is not a "bank" unless it is a "commercial bank," a wholly unauthorized

EXHIBIT B COP

administrative repeal of several sections of the Financial Code expressly stating the contrary. A third "blind spot" is your counsel's quotation of a statute (Fin. C. § 1561) authorizing contractual alternatives to the general rules of the Civil Code--without any recognition that FITCO's trustors, competent adults, have contractually agreed to these precise alternatives. I shall address these and other issues herein in the sequence set forth by your counsel in the January 9 letter.

1. FITCO is not a commercial bank.

We have at least one point of agreement: FITCO is not a "commercial bank." FITCO has never claimed to be such, held itself out as such, nor engaged in the commercial banking business as defined in the Financial Code. Although FITCO as a trustee does receive "deposits" of money or property in the common usage sense of that term, it does not deal in debtor-creditor "deposits" as such are sometimes defined in the specialized jargon of the financial community. Nor is it in our view semantic heresy or misleading to the public to use the term in its common usage sense, for the Legislature itself has done so in Financial Code Section 1586, authorizing trustees to "deposit" court trust "moneys" with "trust companies."

The Department's repeated charges of misleading the public are severely undermined by the fact that not one single consumer complaint against FITCO has been received by the Department. I believe the explanations for this to be at least two-fold. First, FITCO provides such a valuable and satisfactory service to its customers that few if any have found anything to complain about. Second, and most important, no genuine living being has been misled. Your staff assigns to terminology formerly used by FITCO certain esoteric term-of-art import which the unsophisticated customer and investor simply does not ascribe to those terms. The sophisticated customer and investor, on the other hand, even if he or she did read those meanings into the words, is well aware by the time he or she has read and signed the Letter of Instructions that a relationship of trust is being created, that his/her funds are being "entrusted" and not "loaned," and that the trustee's fee will be all excess earnings above a specified T-bill-based rate. Contrary to your counsel's suggestions, this arrangement is perfectly lawful under the law of trusts and trust banking.

Use of the terms "Bank" or "Intrust Bank" do not mislead customers. Consumers are generally aware that there are a broad spectrum of financial institutions available and, in our judgment, they simply do not make the kind of generic assumptions your staff attributes to them. Authorities across the nation acknowledge that the term "bank" can mean any number

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of things. Most recently, the U.S. Supreme Court addressed the issue of "nonbank banks" in the context of the Bank Holding Company Act of 1956. In Board of Governors of the Federal Reserve System v. Dimension Financial Corp, et al., Number 84-1274, 86 D.A.R. 363 (January 22, 1986), the Supreme Court rebuffed the Board's attempt to redefine the narrow definition of "bank" (used in Section 2(c) of the Act to confine Board jurisdiction under the Act) so as to reach many institutions theretofore unregulated by the Board. Many of those institutions are "commercial banks," in the sense that they deal in debtor-creditor deposits, but do not meet the extremely narrow definition of "bank" Congress chose to use in that particular statute. Hence, the odd term "nonbank banks."

The 1956 Act originally defined "bank" as ". . . any national banking association or any State bank, savings bank, or trust company." (12 USC § 1841(c); 1964 ed.) This common, broadly inclusive usage proved far too broad for the narrow purposes of the Act, so Congress narrowed it once in 1966 and again in 1970, finally defining "bank" for that purpose as any institution ". . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." The Board sought by regulation to expand that coverage to banks offering NOW accounts (not true demand accounts but functionally equivalent in practice) and to characterize dealing in certificates of deposit and money market instruments as "commercial loans." The Court upheld the ruling of the Tenth Circuit that those "banks" are not "banks" under the Act. Among the petitioners held not to be "banks" therein were nine banks bearing the name "bank" under state laws. See opinion below at 744 F.2d 1402 (10th Cir. 1984).

Obviously to a layperson the conclusion that a bank is not a bank would be difficult to grasp. Your staff's bald assertion (notwithstanding the Financial Code's repeated reference to trust companies as a class of bank) that no bank is a bank unless it is a commercial bank is just as confusing. As one federal court recently noted, only the phrase "commercial bank" clearly imports that character: "Since there are a variety of kinds of 'banks'--investment banks, mutual savings banks, and even blood banks--the key is clearly meant to be the words 'commercial'." (Memorandum opinion, Independent Bankers Association of America et al. v. Conover, No. 84-1403-Civ-J-12 (M.D. Fla., Feb. 15, 1985); see also, Goldfeld and Chandler, The Economics of Money [illegible] Ed. 1981).) I would [illegible] that to the layperson the term "bank" is a generic term which he/she understands applies to a broad variety of financial institutions. Consumers know that "banks" offer a broad range of services, that some are specialized in various areas of service, that they do not all offer the same programs or interest rates. Perhaps an occasional consumer finds to his or her surprise that a given bank does not offer an expected service; that does not mean the consumer has been defrauded or misled by use of the term "bank." He or she is simply at the wrong bank, perhaps the wrong class of bank. In fact, there are very few full service banks in California, though it is doubtful that this fact is generally known to the banking public. Is this misleading? I am thoroughly convinced that not one person has funds placed with FITCO with the erroneous belief that FITCO is precisely the same *type* of bank as Crocker or Wells Fargo. There is nothing misleading or inappropriate in FITCO's employment of the common usage of the generic term "bank."

Nor in fact is such usage contrary to the more discrete banking usage of the term. As your counsel points out, Financial Code Section 103 provides:

> Banks are divided into the following classes:
>
> (a) Commercial banks.
>
> (b) Trust companies.

Prior to 1973 there was a third class, "savings banks." Were they, too, misleading the public by printing "banking hours" on their doors? In 1931 the Supreme Court ruled that "banking" includes the business carried on by trust companies. (*First National Trust and Savings Bank of San Diego v. Industrial Acc. Comm'n.* (1931) 213 Cal. 322.) Is the Supreme Court misleading the public?

Financial Code Section 102 provides, in pertinent part:

> The word "bank" as used in this division means any incorporated banking institution which shall have been incorporated to engage in commercial banking business *or trust business* . . . . (Emphasis added.)

Financial Code Section 600(c) states, in pertinent part,

> (c) In case the bank is, or is proposed to be, a trust company (other than a commercial ~~bank authorized~~ to engage in trust ~~business~~ .
> . . .

The Legislature has defined FITCO as a bank. Is the Legislature misleading the public?

FITCO's charter issued by your Department refers to FITCO as "said bank," which is "authorized to transact a trust banking business." Section 407 of the Financial Code requires that charter to be conspicuously displayed to the banking public. A copy is enclosed as Exhibit 1 for your review. The face sheet of your Report of Examination (copy enclosed as Exhibit 2) refers to information in the report being based upon "the books and records of the bank," that it is "furnished to the bank" for use in the "supervision of the bank"; it prohibits "the bank" from unwarranted disclosure and refers to FITCO as "Bank Number 1136."

Your own regulation, Section 10.111, states:

> "Bank" has the meaning set forth in Financial Code Section 102. "Bank" includes state banks, national banks, and foreign banks; also, "bank" includes commercial banks and trust companies. However, "bank" does not include international banking corporations. [Title 10, Cal. Admin. C. §10.111. (Emphasis added.)]

Is your own Department misleading the public? FITCO has done nothing more than use the Department's own description of FITCO--a bank engaged in trust banking rather than commercial banking. "First Independent Trust Company, The Intrust Bank" communicates precisely those entirely accurate facts about the authority and activity of FITCO. Every branch of state government has formally declared that a trust company such as FITCO is a "bank" and that the trust business is a form of "banking" or, in your Department's own appropriate language, "trust banking."

Your counsel has shown us no authority for the contrary proposition that despite clear legislative, judicial and administrative expressions to the contrary only commercial banks are banks. Again, we do not dispute the assertion that FITCO is not a commercial bank--but find unsupportable and illogical the conclusion that FITCO is not, therefore, any kind of bank.

Similarly, your counsel's objection to the use of the words "deposit" and "Trust Rate savings account" depend upon the unsupported assumption that consumers will ascribe certain disputed and esoteric meanings to these terms. In fact, even in banking jargon the word "deposit" is used alternatively to describe [illegible] commercial "debtor-creditor" ~~deposit, often~~ termed a "general deposit," or a "special deposit" which creates some other relationship, most often bailee-bailor or trustee-benificiary. See, Schlichting, 1 Banking Law § 9.02

(Matthew Bender & Co., 1983). There is no all-inclusive and all-exclusive definition of the term "deposit." (*Id.*, at § 9.03. See, *First National Bank of St. Cloud v. Hirning* (S.D., 1925) 204 N.W. 901.)

Commercial banks commonly indulge in casual usage of "deposit" terminology as well, ostensibly realizing that common English is superior to esoteric jargon when communicating with consumers. For example, I enclose herewith as Exhibit 3 an enlarged copy of River City Bank's currently utilized signature card. Note that it states, as to a checking account, that "all funds now on deposit or which may be placed on deposit in said account *shall be the property of the undersigned*" (depositor). Obviously this is untrue, since commercial banking deposits become the "property" of the bank once deposited and the "property" of the depositor is a debt owed to him/her by the bank.

The Legislature has itself used the word "deposit" in both senses, defining commercial banking as receiving deposits of money yet authorizing deposit of trust moneys with trust companies (Financial Code §§ 763, 1586). The result, in California statutory language, in financial community usage, and in common English, is that the word "deposit" encompasses *both* transfers and means just what the dictionary says and no more:

> Something placed for safekeeping, as a: money deposited in a bank, b: money given as a pledge. [*Webster's Seventh New Collegiate Dictionary* (7th ed., 1967).]

Note the breadth of that lay definition. It incorporates three distinct relationships as to transfers of funds: bailor/bailee or trustor/trustee ("safekeeping"), debtor giving security to creditor ("pledge") or general deposit. Laypersons, who speak dictionary English and not the dialect of financiers and regulators, ascribe to the words "deposit" only the general meaning that X leaves property in the custody of Y, a wholly accurate description of what happens at FITCO.

A savings account is an account where a person can place his or her savings. I recognize that "savings deposit" statutorily refers to a type of general deposit taken in by commercial banks (Financial Code § 105). Again, however, it is incomprehensible that any consumer would fail to realize by the time he or she opens a Trust Rate account that such is not a conventional commercial passbook arrangement. The terms of the relationship are disclosed fully in the Letter of Instruction and Memorandum of Understanding, which quite clearly describes an investment by a trustee of the trustor's savings placed in the trustee's custody, with specific notation that these are not demand deposits but subject rather to a prior notice requirement. Again, not a single customer has complained that he or she thought this would be a conventional commercial passbook account.

In summary, FITCO does not engage in commercial banking activity and there is absolutely no evidence any consumer has ever placed funds with FITCO mistakenly believing FITCO to be a commercial bank. FITCO has been legislatively, judicially and administratively defined as a "bank" engaged in "trust banking" and will continue to so describe itself in a fashion designed to ensure that members of the public will understand that FITCO is engaged in the trust business and that FITCO, as a bank, is subject to the intensive scrutiny of the State Banking Department, a scrutiny that is confidence-inspiring to consumers and federal agencies alike, as is discussed below. The word "bank" tells the public that FITCO is regulated as closely and carefully as other banks. If FITCO must endure such regulatory intrusiveness because it is a bank, there is no reason the public should not be aware that FITCO is, because it is a bank, so closely regulated.

2. FITCO has breached no fiduciary duty.

In your counsel's letter, and in related discussions, criticisms have been leveled against the Trust Rate Program for a number of reasons, not all of them clear. I understand those objections principally to be:

A. That pooling ("commingling") funds of multiple trusts breaches or impairs the duty to account.

B. That holding funds or securities in FITCO's own name constitutes self-dealing.

C. That contractual provisions that the trustee's fee shall be all earnings in excess of a specified trust rate constitutes self-dealing.

D. That failure to disclose the trustee's fee in dollars breaches the duty of disclosure.

E. That these alleged breaches somehow transmute trust business into commercial banking.

F. That FITCO customers have been defrauded since they each thought they were dealing with a commercial bank.

Each of these objections share two common defects: Not one customer has surfaced with the type of complaint imagined by your counsel, and each of the challenged features of Trust Rate is lawful and contractually authorized.

I enclose herewith as Exhibit 4 another copy of the new proposed Declaration of Trust which FITCO contemplates substituting for its existing Letter of Instruction by agreement with its existing Trust Rate customers. This document has been prepared with the objective of improving the quite adequate disclosure and authorization aspects of the existing Letter of Instruction and thereby addressing the Department's aforementioned concerns regarding the operation of Trust Rate. (This is the same document delivered just prior to our January 16 meeting as to which we have not yet received your counsel's promised comment.) Additionally, the factual recitals set forth at pages 5-7 of your counsel's letter do not accurately reflect FITCO's past, nor particularly its current, mode of operation. For example, assets acquired with Trust Rate funds are now specifically identified to individual customers' accounts, and a new simplified accounting procedure has been put in place providing for quarterly cashflow statements and a year-end printout (also available on an interim basis upon request) detailing assets and account activity. A sample of this new accounting format was provided to your staff under separate cover on January 28 of this year. Another copy is enclosed herewith for your review.

I believe it would be most productive for all parties, and particularly the banking public, if we focus our attention upon the proposed Declaration of Trust and new accounting procedure in addressing the Department's concerns about trust operations--assuming, that is, that the Department has initiated this dialogue with the objective of influencing future conduct rather than simply criticizing past operations. The proposed Declaration in conjunction with the time-honored ability of competent trustors to make their own contracts will, when implemented, obviate any real question regarding the current operation of Trust Rate.

One central misperception in your counsel's criticism of Trust Rate is a blindness to the significance of the latter half of Financial Code Section 1561:

> Trust funds . . . . shall be invested as provided in the Civil Code, subject to such provisions as may be contained in any trust instrument. [Emphasis added.]

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Pursuant to Section 1561, above, the general Civil Code rules of trust investment may be deviated from pursuant to trust agreement provisions. FITCO's trustors have specifically authorized FITCO to hold those assets in FITCO's own name, to invest funds from their individually managed accounts into the Trust Rate Program, and to pay to itself as its fiduciary fee any earnings in excess of a specified amount. Those authorizations are made particularly clear by the enclosed proposed Declaration, which specifically discloses and approves the percentile fees on income and third-party revenues collected as compensation, and specifically waives accounting of actual income received beyond those monies to which the trust is entitled pursuant to the Declaration. Each of these authorizations is lawful and enforceable under California law.

A. The now-discontinued pooling of Trust Rate assets offends no fiduciary responsibilities.

There is nothing objectionable under the law of trusts about commingling multiple trusts' funds provided doing so does not impair the trustee's ability to perform the objectives of the trust and its own obligations thereto. The commingling provision of Civil Code Section 2236 extends only to the commingling of the trustee's money with that of a trust, and at that only imposes additional obligations, not a prohibition. What matters is that the trustee's own books and records accurately reflect each trust's beneficial interest in any such pool, so as to ensure that upon withdrawal from or dissolution thereof the proper sums or assets may be transferred into the individual trust(s). FITCO's records have at all times afforded that capability. Most importantly, FITCO's current practice includes identification of specific assets to each trust, so that Trust Rate no longer has a commingling aspect. There does exist a common interest-bearing insured account into which uninvested cash is "swept" daily pending investment, which as you know is common industry practice and not unique to FITCO, due to the prohibitive cost of maintaining individual accounts for such small and transitory sums. Even this innocuous practice is nonetheless fully disclosed and authorized under the proposed Declaration.

B. Holding assets in a trustees's name is lawful and appropriate.

It is not, as your counsel suggests without citation of authority, objectionable for a Trustee to hold securities in its own name. Indeed, these particular instruments may be held only by financial institutions in their own name, and federal law specifically authorizes those institutions to so hold and acquire them for their trusts:

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> Loans made by eligible lenders in accordance with this part shall be insurable by the Secretary whether made from funds fully owned by the lender or from funds held by the lender in a trust or similar capacity and available for such loans. (20 U.S.C. 1076.)
>
> A FISLP note may not be assigned except to an eligible lender. (34 C.F.R. § 682.513(a) (1985).)

Those instruments simply may not be held in the name of Jane Doe or Jane Doe's trust, etc.; they must by Federal law be made and held by the institution in the institutional name. Additionally, counsel's objection to this practice ignores the fact that trustors have the right to anonymity in their trusts:

> A trust company, its officers and employees, shall not disclose any information to any person concerning the existence, condition, management and administration of any private trust confided to it, except: [where specifically authorized, necessary, or lawfully compelled]. [Fin. C. § 1582; emphasis added.]

Confidentiality is of the utmost importance in trust relations. It is presumed that the existence of a trust and the identity of the beneficiary will not be disclosed unless specifically authorized. Holding in the trustee's name is a common practice where expedient or appropriate, and in this circumstance is absolutely necessary under federal law as to these securities. I frankly am troubled by the Department's unwarranted criticism of common trust practices, given the billions of dollars in trust monies administered by the trust departments of departmental banks.

For example, I enclose herewith as Exhibit 5 a copy of the Department of Health Services' mandatory, nonamendable trust agreement for "private superfunds" required of hazardous waste facility operators. That agreement specifically authorizes a number of the acts which your counsel insists trustees may not lawfully perform despite their authorization in trust agreements. These are:

a. Commingling assets of multiple trusts. See, Sections 7(a), 8(c) of the DHS Agreement;

b. Failure to immediately invest cash: DHS Agreement, Section 6 (iii);

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c. Holding securities in the trustee's own name: DHS Agreement, Section 8(c);

d. Self-dealing by selling trusts the trustees' own assets, securities or debt: DHS Agreement, Sections 7(b), 8(d);

e. Providing periodic accountings limited to the "bottom line," the current value of the trust. DHS Agreement, Section 10.

I submit that these are lawful and in some cases quite common features of private trusts.

C. Trust Rate trustee compensation is a matter of contract between competent parties and is entirely lawful.

Provisions in the existing Letter of Instruction and the proposed Declaration of Trust which authorize the trustee to collect as fees all income above a specified amount payable to the trust violate no law and are perfectly enforceable. Civil Code Section 2274 provides, in pertinent part:

> If the declaration of trust contains provisions for a trustee's compensation, the trustee shall be entitled to be compensated in accordance therewith.

That section goes on to provide authority for judicial increase of that compensation; there is, however, no authority for reduction of the compensation stated in a valid declaration of trust executed by an informed, competent trustor.

This fee arrangement is not "self-dealing" and creates no conflict of interest. Because the trustee's investment discretion is confined by a direction that funds be invested in insured, guaranteed, or full faith and credit goverment obligations, there is absolutely no potential conflict from a temptation to make high-risk investments to maximize income. These are enforceable arm's length contracts by competent adults to pay fees for an extraordinary investment opportunity providing excellent income and excellent security.

In contrast, far less beneficial trust agreements are upheld ~~in California law when entered~~ into by ~~competent adults in the~~ absence of fraud. In Marsh v. Home Federal Savings and Loan, (1977) 66 Cal.App.3d 674, it was held that lenders' impound accounts constitute trusts for the benefit of the borrower and as such invoke all conventional duties and obligations of a trustee. Pursuant to the terms of the deed of trust in question, Home Federal was authorized to commingle those trust funds in its general fund and was released of any obligation to pay the trust any interest therefor. Faced with a trust wherein the trustee applied *all* of the trust res to its own benefit and earned absolutely *no* income for the trust, the court nonetheless held that the general rules prohibiting such an arrangement would be abrogated by a valid agreement.

> When, however, the parties adopt a provision which does not contravene a principle of public policy and which contains no element of ambiguity, the court has no right, by process of interpretation, to relieve one of them from any disadvantageous terms which he has actually made . . . To force the lender to account for and pay Marsh for the earnings from the agreed use of the impounds would be contrary to the express agreement. [66 Cal.App.3d at 684-635; citations omitted.]

Certainly if a trustor can bind himself to Home Federal's agreement whereby the trustor wholly commingles the funds and wholly absorbs all income, such a trustor can agree to release all interest in income in excess of the specific return provided him in Trust Rate. This is what Trust Rate customers have done, in consideration for which they have received the return for which they have bargained. These are binding, lawful contracts.

D. *The beneficiary's right to disclosure is defined by the trust's right to receive.*

The law of trusts does not require FITCO to volunteer to the trustor or beneficiary an accounting for the predetermined fees earned pursuant to the agreement. The trustor, having contractually agreed to those fees, divests himself and the trust of any equitable interest therein. Under Civil Code Section 2235 the presumption of undue influence common to other dealings involving self-interest is expressly made inapplicable to agreements for trustee compensation. Those are presumed to be arm's length transactions in the absence of facts--not mere speculation--to the contrary. In *Assets Corporation v. Perrin Properties*, (1941) 48 Cal.App. 2d 220, the Court of Appeal held that,

> There is no doubt the trustee occupied a fiduciary relationship toward the defendant and that the bank was bound to disclose to them all material facts within its knowledge and unknown to them, *provided the suppression*

> *of such facts detrimentally affected their interest in the property* . . . . [48 Cal.App.2d at 226; emphasis added.]

The duty of disclosure is thus confined by that limitation of "materiality," turning upon whether the information is relevant to the beneficiary's interest in the property. A beneficiary *has* no beneficial interest in fees previously bargained away at arm's length.

This is nothing new to the law of fiduciaries. In *Gray v. Yarborough*, (1923) 61 Cal.App. 724, a fiduciary was directed to sell a parcel of land for at least a given price, it being agreed in writing that anything he received exceeding that sum he could have as his commission. All that the principal asked was that the sale of the parcel yield $3,200 net to the principal, at least $1,000 of that paid to him in cash and the balance in a note. The fiduciary found a buyer who offered to pay $4,000, the full $1,000 of it in cash. The fiduciary, desirous of getting his own compensation in cash rather than an interest in a note, misrepresented to his beneficiary that the buyer could only raise $200 cash and convinced the beneficiary to take his $3,200 as $200 cash and a $3,000 note. This enabled him to convert the other $800 cash to his fee.

Obviously that fiduciary's misrepresentation of the available cash/note mix was actionable, inasmuch as the information misrepresented was directly relevant to the beneficiary's interest in the asset and proceeds. As to the sum of compensation received or the total sales price, however, the court held that these sums fell outside the relation of trust, and thus outside the duty of disclosure, having been bargained away by contract and the beneficiary thereby divested of any beneficial interest in those proceeds.

> If the sale had been made in accordance with the terms of the contract of agency, any false representations as to what defendant was to receive by reason of the sale would have been immaterial and not actionable fraud, because plaintiff had no interest in any excess received above the fixed price, and defendant was not plaintiff's agent for the purpose of obtaining such excess but was acting for himself in that regard and in his own interest, the only restriction being that he must not violate his duty to plaintiff in his efforts to obtain or increase his own compensation. The defendant would have had the right, under the express terms of the

> contract, to such excess, without consent and against the objection of plaintiff. The plaintiff knew that the defendant and his associates were to receive property of some character in exchange for the former's land, and the nature, location, or value of such property was not material, nor did the want of knowledge thereof in any manner influence plaintiff's conduct. But defendant was obligated to use his best efforts to obtain for his principal an initial payment of "not less than $1,000 cash net to owner." If he willfully failed to discharge this obligation and induced the plaintiff, by false and fraudulent representations, to make the sale on a cash payment of only $200, such fraud is actionable. [61 Cal.App. at 730.]

The court in Gray was applying the same Civil Code sections with which your counsel assails Trust Rate compensation and disclosure. Gray remains the law. As mandated therein, FITCO exercises its best efforts to obtain for its Trust Rate customers precisely the benefit bargained for, and has faithfully and without fail credited all such sums to those trusts. More importantly, the proposed Declaration of Trust expressly states the disclosure limitation already implied by law: "I specifically waive any accounting by you to me for the income actually earned on my said assets." It is anticipated that this language, once agreed to by Trust Rate trustors, will completely dispose of disclosure objections. The Declaration itself discloses exactly what the trustee's fee will be and waives any accounting for those sums.

In the Marsh v. Home Federal case discussed above, the Court specifically held that the trustee's duty to account is subject to contractual limitations or waivers.

> A trustee has a general duty to invest trust property so that it is productive for the beneficiary (Rest.2d Trusts § 181) and to account for any gain realized from the use of trust funds (Civ. Code, §§ 2229, 2237; see Abrams v. Crocker-Citizens Nat. Bank, supra, 41 Cal.App.3d 55, 60). When, however, the parties adopt a provision which does not contravene a principle of public policy and which contains no element of ambiguity, the court has no right, by process of interpretation, to relieve one of them from any disadvantageous terms which he has

> actually made (Williston on Contracts (3d ed. 1961) § 609.). [66 Cal.App.3d at 684.]

The trustor's capacity to waive accounting is well-settled in the law of trusts. See, Cal.Jur.3d, Trusts, § 15; Restatement of Trusts 2d, § 173. To obviate any further objection it is proposed that by substitution of the enclosed Declaration the implicit waiver of accounting for fees, arising from the contractual divestiture of interest therein, will be replaced with an express, informed waiver.

E. FITCO is not engaged in commercial banking.

Certainly each of the actions taken by FITCO on behalf of existing Trust Rate investors has been lawful and faithful to the instructions and authority given FITCO at the creation of those trusts. The proposed Declaration goes several steps further in an endeavor to resolve your concerns, and to avoid similar concerns perhaps being raised someday by a customer--although I would point out, again, that not one single customer has found cause to complain. Even were your counsel's objections as to Trust Rate's operation valid, however, this could not transmute what clearly is a trust relationship to commercial banking. The import of the objections to usage of banking terminology would appear to be that the hypothetical customer (who has yet to surface) is misled into believing that he or she is being offered a commercial banking service. Even were FITCO so inadvertently holding itself out as a commercial bank this would not constitute conducting such business. Clearly neither has occurred.

F. FITCO has dealt truthfully and faithfully with its customers.

I reject wholesale your counsel's characterization, at pages 5-7 of her letter, of FITCO operations and advertising. The misleading selective quotation therein of promotional language paints a patently false caricature of the truth. I will not review again the validity of the individual terms as FITCO has employed them, but suggest scrutiny be directed to the Department's misusage of FITCO's language. Your counsel contends, at page five, that FITCO advertised as a "state-chartered bank," with "depositors" and offered a "Trust Rate Savings Account" "guaranteed by the U.S. Government" with "liquidity" and "high interest rates."

FITCO has never advertised that Trust Rate was guaranteed by the Government. All representations have been truthful claims that Trust Rate funds are invested in government-backed instruments. Everything else in that statement is true within the original context wherein it was presented to the public.

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The brochure to which counsel refers has, as communicated to you in my letter of November 25, 1985, been withdrawn from circulation. Counsel's characterizations thereof, however, require rebuttal inasmuch as they form the faulty basis of an unsubstantiated claim that FITCO customers--none of whom have complained--have been defrauded.

FITCO is, as mentioned, a "California banking corporation" authorized to conduct "trust banking" business. I have no apologies to offer for the use of those terms nor for the use of the perfectly appropriate and informative hybrid term "Intrust Bank." The use of "interest rates" to describe yield is the most accurate phrase one could imagine for the concept most easily grasped by consumers choosing among comparable investments. I am unaware of any commercial banking monopoly on that term. The claims regarding the magnitude of that return are true and correct numerically as well as in the claim of superiority to available alternatives of comparable security. FITCO is fully cognizant of your objections to a trust company's use of the phrase "savings account." While I thoroughly disagree with the contention that consumers have been misled by that phrase, it is my understanding that out of an abundance of caution FITCO has determined to discontinue the use of that particular term for the time being. You will note, for example, that this phrase as well as other financial terms of art once employed in the Letter of Instructions appears nowhere upon the face of the Declaration of Trust enclosed herewith.

Trust Rate is in practice a highly liquid investment inasmuch as there exists a readily available secondary market for GSLP instruments. Analogous in liquidity to NOW accounts, Trust Rate is by express and clear contract provision subject to up to 30 days' notice prior to withdrawal but in practice can commonly be liquidated within one or two working days or even within the same working day. This right of the bank to require 30 days' notice is from the customer's perspective the functional equivalent of the same right exercised by commercial banks as to "savings deposits" as those are defined by your own regulations in Section 10.163(b).

> "Savings Deposit" means a deposit: . . . (b) with respect to which the depositor is not required by the deposit contract but may at any time be required by the bank to give notice in writing of an intended withdrawal not less than 30 days before such withdrawal is made . . . .

Trust Rate has, then, liquidity equivalent to that of "savings deposits" in commercial banks and I cannot agree that prior references to Trust Rate as a "liquid savings account" in that discontinued promotional brochure have misled a single consumer as to the functional liquidity of Trust Rate. I point out again that if any customer has experienced a liquidity problem some evidence of that would certainly be known to FITCO or to your Department, and no such complaint has surfaced. I would attribute this in large part to the very clear language of the Letter of Instructions itself: "deposits may be withdrawn at any time upon proper notice . . . A thirty day notice to close the account may be required by fiduciary." The proposed Declaration enclosed herewith refines that language, deleting the "at any time" language together with the banking terminology which your Department has found so troublesome despite its general accuracy. I see no reason why the substitution of the Declaration by agreement with the trustors should not solve those difficulties.

Your counsel's description of Trust Rate as a commercial banking business is erroneous in both detail and conclusion. In particular, FITCO has never claimed or implied FDIC protection to its customers.

It is made quite clear to customers who place funds in Trust Rate that they are establishing a trust. The following language excerpted from the now discontinued Trust Rate brochure was not quoted by your counsel, perhaps because it destroys her argument that consumers do not realize that FITCO is engaged in the trust business rather than commercial banking:

> First Independent Trust exercises powers granted under State Banking Law. Its primary functions thereunder are the administration of decedent's estates, guardianships of minors, conservatorships for adults, testamentary and private trusts, agencies in the personal trust area, pension and profit sharing trusts for corporations, along with IRAs and Keoghs for individuals in the pension trust area.
>
> As a trust banking corporation, we are required by law to deposit security for all court and private trusts accepted by us.
>
> First Independent Trust with its many large accounts, has focused its efforts on serving the middle range of trust clients, $50,000-$500,000, while other banks have

> priced themselves out of this market. The types of accounts handled by First Independent Trust range from $2,000 IRA's, to $Multi-Million pension and welfare trusts.
>
> First Independent Trust is the only bank nationally using trust monies to fund these government guaranteed student loans through their investment programs for trusts.
>
> Our 7 key employees and officers collectively represent over 200 years of Trust expertise, the greatest in the Valley. Doing business with us . . . is doing business In-Trust . . . .

Compared to these wholly accurate express statements of what FITCO is and does, your counsel insists that consumers think FITCO is a commercial bank because Trust Rate was formerly referred to as a Trust Rate "savings account" and funds placed therein as having been "deposited". From that leap follows another; since consumers assume FITCO to be a commercial bank, consumers assume that any funds placed in FITCO's custody are insured by FDIC, when in fact they are invested in government-insured instruments. Because FITCO has no FDIC insurance, the syllogism concludes customers have been "misled," although no detriment is even alleged. This is nonsense.

I propose we consider another syllogism. Wells Fargo is a departmental bank. It has FDIC decals pasted on every door. Customers know Wells Fargo is an "insured" bank. Wells Fargo accepts funds as trustee. Wells Fargo does not expressly warn customers that assets in its trust department are not insured by FDIC. Customers assume an "insured bank" is insured in all respects, not knowing the niceties of banking law. Wells Fargo invests its trust assets heavily in a blue-chip stock, say Texaco. Texaco collapses, the trusts lose their assets, there is no insurance.

Which consumer has undertaken the greater undisclosed risk? Which customer has received express representations of FDIC protection which are not true as to his funds?

FITCO has told its customers the truth about its charter, its authority, the relationship of trust and the fees, yield and security aspects of the Trust Rate investment in GSLPs. Revisions to existing documentation have been made in response to your Department's input in an effort to solve what in FITCO's view are largely academic disagreements being afforded far more significance than is appropriate. FITCO has demonstrated its good faith and responsiveness despite your Department's unduly aggressive behavior. We look now for reasonable moderation of your staff's constrictive attitude and common ground upon which a healthier relationship between agency and bank can be based.

FITCO cannot and will not accede to the baseless, flawed and outrageous demand that Trust Rate be shut down. Trust Rate is an extremely valuable investment opportunity for FITCO's trusts and no cause has arisen for that opportunity to be discarded.

FITCO does, however, intend to substitute the proposed Declaration or some subsequent refinement thereof for its existing documentation. Of course, those existing trustors who choose not to accept those new terms would have the choices of withdrawing their trust or simply directing FITCO to reinvest those funds in some other asset. Obviously, FITCO will not tell customers they have been misled, which seems to be the sort of "disclosure" your counsel suggests, because that itself would be a false and misleading statement. The affirmative disclosure of relevant features of the proposed documentation is a topic we would be pleased to discuss with you. If existing Trust Rate customers are offered the alternatives of continuing with an even more fully disclosed Trust Rate program or withdrawing therefrom, the wholly hypothetical misunderstandings of the past should be completely mooted. It is this sort of prospective, constructive dialogue in which we find it most productive to engage. FITCO asks your cooperation and assistance in our ongoing effort to improve its service to the public.

3. The proposed Declaration responds fully to your counsel's objections to the revised Letter of Instruction.

In response to item five of your counsel's letter, allow me to point out in the numerical sequence used therein the relevant changes reflected by the enclosed Declaration:

1. The investment direction now specifies investment in a described class of security (which includes CGSLs), rather than in a "Program." It is truthful and accurate and the scope of the investment direction is a matter of private contract between trustor and trustee.

2. Loans are now assigned to individual accounts, as is shown on the enclosed sample accountings.

3. Delet[illegible] counterpart provision.

4. Sample accountings have been supplied to the Department under separate cover, and copies enclosed as Exhibit 6.

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5. That former third paragraph was an attempt to address your Department's term-of-art concerns by expressing in such terms that this is not a commercial banking debtor-creditor relationship. It has been deleted from the Declaration which instead uses the word "trust" some twenty times and recites in the last paragraph that funds transferred to FITCO "for my trust" are to be held in accordance with "trust law" "and not in a depository debtor-creditor relationship."

6. The recital as to knowledge of "all other facts that might affect my decision" has been deleted. This is, by the way, a common type of contractual recital.

7, 8. The Declaration plainly discloses gross yield on the loans themselves.

9. It is basically inconceivable that an account could not be closed in thirty days. As stated above, CGSLs can be and regularly are readily transferred or sold by FITCO in the secondary market.

I believe the Declaration more than adequately addresses the concerns voiced regarding the Revised Letter of Instruction.

4. FITCO is an Eligible GSLP Lender.

It has been suggested that FITCO is not eligible to participate as a lender in the CGSL program at all. Before undertaking to explain in detail the error of this conclusion it may be appropriate to consider FITCO's stature in the student loan program.

FITCO ranks sixth nationally in the issuance of California Guaranteed Student Loans (CGSLs) and first in Parental (CLAS) loans. FITCO has written over two hundred million dollars in student loans in the past seven years, a vast proportion of which are held by the California Student Aid Commission as assignee of the original lender (FITCO) through the Commission's secondary marketing program created by state law. Brash and inaccurate accusations tending to cast aspersions upon FITCO's eligible lender status and insurability of FITCO CGSL's would, if publicized, cause substantial and unnecessary injury to a broad range of financial and governmental institutions as well as students, schools and FITCO's customers. Such unnecessary disaster would be the proximate and accountable result of a state agency eagerly presuming to displace a federal agency's regulation of a federal program.

FITCO has over seven years' experience and familiarity with the U.S. Department of Education and the reverse is true as well. Obviously, the Department of Education is well aware that "First Independent Trust Company" is a trust company, and well aware of the dollar volume in CGSLs being written by FITCO. The regulatory agency having jurisdiction over FITCO's status as an eligible lender has expressly granted such status and contracts of insurance for FITCO-originated loans and has expressed no particular dissatisfaction with FITCO's lending practices and standards of diligence and scrutiny.

FITCO has sought and obtained independent counsel and confirmation that FITCO is indeed an eligible lender inasmuch as it does meet the Department of Education's definition of "state chartered bank" and, not being a commercial bank, the institution is not engaged in consumer credit loan activity through the application of institutional assets.

Your Department's concern apparently arises from the following statutory definition from 20 U.S.C. § 1085(g)(1)(A):

> (g)(1) Except as provided in paragraphs (2), (3), and (4), the term "eligible lender" means--
>
> (A) a National or State chartered bank, a savings and loan association, or a credit union which--
>
> (i) is subject to examination and supervision by an agency of the United States or of the State in which its principal place of operation is established, and
>
> (ii) does not have as its primary consumer credit function the making or holding of loans made to students under this part unless it is a bank which is wholly owned by a State;

The Department of Education itself has interpreted those terms as follows:

> Lender: A lender, including a subsequent holder, that is--
>
> (a) A National or State chartered bank, a mutual savings bank, a savings and loan association, or a credit union that--

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> (1) Is subject to examination and supervision in its capacity as a lender by an agency of the United States or of the State in which its principal place of operation is established; and
>
> (2) Does not make or hold loans to students under the GSLP that total more than one-half of its consumer credit loan dollar volume, including home mortgages, unless it is a bank that is wholly owned by a State; or
>
> (b) A pension fund as defined in the Employees Retirement Income Security Act; or . . . . [34 CFR § 682.200 (1985).]

And interestingly that same regulation sets forth a distinct and separate definition of the subcategory "commercial lender":

> Commercial lender: A commercial bank, savings and loan association, credit union, or mutual savings bank. [Ibid.]

Compare subdivision (a) of "lender" with "commercial lender." "State chartered bank" does not necessarily imply "commercial bank," as your counsel assumes. "Lender" encompasses noncommercial "banks"--the type of "bank" that your counsel denies exists--provided that institution meets the criteria applied to all financial institutions:

(1) Regulation by state or federal banking authorities, and

(2) a 50% limitation on investment of bank capital in GSLPs.

These alternate categorizations of banks either upon their commercial character or upon the type of regulatory scrutiny to which they are subjected is by no means unique:

> Classification of banks
>
> Banks are classified by function (special clearance banks, commercial banks accepting demand deposits, thrifts specializing in savings) or chartering authority (federally chartered national banks or state chartered banks). [Schlichting et al., 1 Banking Law §1.03 (Matthew Bender & Co., 1983).]

These two means of classification are prevalent in federal banking terminology. Federal laws contextually defining "banks" vary broadly in their of application that term, depending upon the feature of banking which is of significance to a particular statutory scheme. Most commonly that definition relates either to a specific banking function sought to be regulated, or simply to whether the subject institution is regulated by banking regulators. The Bank Holding Company Act, for example, uses the extremely narrow definition of bank litigated in the Dimension Financial case, a definition which goes beneath the conventional "commercial bank" and reaches only commercial banks issuing a narrowly defined class of "commercial loan." There are banks in California which would meet your Department's definition of "bank" yet not that set forth in the Bank Holding Company Act. Indeed, that is what the Dimension Financial case is about, the Board's futile attempt to reach a broader spectrum of commercial banks by expanding by administrative fiat that uniquely narrow definition.

Enclosed herewith as Exhibit 7 is an appendix of "bank" definitions culled from various federal statutes which demonstrate the range of definitions variously employed depending upon the statutory propose. One common type is that employed by the Internal Revenue Code at 26 U.S.C. Section 581, providing that "bank" means a "bank or trust company" whose business consists of "receiving deposits . . . or of exercising fiduciary powers," and which in either case "is subject to supervision and examination by State or Federal authority over banking institutions." Almost identical language is used in 15 U.S.C. Section 78c(a)(6), 15 U.S.C. Section 806-2(a)(2) and 15 U.S.C. Section 80a-2(a)(5). 26 U.S.C. Section 408, defining "banks" eligible as custodians of IRAs, encompasses any corporation subject to the scrutiny of a state banking department under state law. See also 12 U.S.C. Section 36(h).

Other sections in that appendix define "bank" with narrower meanings for the discrete purposes of those particular statutory schemes. "Banks" under those statutes might only include commercial banks (15 U.S.C. § 2113(f)), any national bank association or any bank or trust company under federal authority in the District of Columbia (12 U.S.C. § 202) or any number of other specialized, ad hoc meanings.

Of all the possible meanings of "State-chartered bank," Congress and the U.S. Department of Education [illegible] in the student loan context to use the type of broad definition encompassing any corporation chartered, examined and supervised by state banking authorities, definitionally distinguishing "commercial lender" as a subcategory therein. It is far too late to deny that FITCO has been chartered under state banking laws and that FITCO has been subjected to your examination and supervision. Whatever your staff's subjective definitions may be, FITCO is undoubtedly a "state chartered bank" subject to the type of state supervision contemplated and required by 20 U.S.C. Section 1085(g)(1)(A).

The second criterion of eligibility under that section turns upon the definition of "primary consumer credit function." While "consumer credit" is usually defined by the borrower's identity and borrowing purpose, here again the statutory objective colors the meaning of "primary consumer credit function." The concern underlying that condition has to do with the impact of that lending activity upon the lender, not the borrower. Here the statutory objective was to avoid the bank itself from investing its own capital heavily in GSLPs to the detriment of its own position and ability to faithfully perform its own obligations and duties.

Neither the statute not the regulation indicates whether a lender's "consumer credit function" was intended to include loans which are made or held by a trust for which the lender is trustee. The Department of Education has confirmed our finding that the legislative history of the Higher Education Act of 1976 contains no explanation of the purpose of the lending limitation. According to officials who were in the Department of Education in 1976, the lending limitation was imposed in response to a situation involving the Labor Finance Industrial Bank of Denver, Colorado. That bank was affiliated with an educational institution, invested its own funds exclusively in GSLP loans, and was subsequently found to have violated prohibitions on accepting inducements from educational institutions to make loans to those institutions' students.

The limitation on GSLP lending was enacted to curb such abuses of a bank's consumer credit function. Significantly, however, in the same legislation, Congress authorized pension funds to be eligible lenders with no limitation on the proportion of GSLP loans that the pension fund could make and hold. See Higher Education Act of 1976, 435(g)(1)(B), codified at 20 U.S.C. § 1085(g)(1)(B). Like trust funds held by a bank, pension funds are trust funds, and the pension fund trustees are subject to the same fiduciary duties as bank trustees. See 29 U.S.C. § 1104. Indeed, under the Employee Retirement Income Security Act, the trustee of a pension fund may be a bank or trust company qualifying as an eligible lender under the GSLP.

By placing no limitation on GSLP lending by pension funds, Congress implicitly indicated its determination that the higher fiduciary standards applicable to trustees of a trust fund constituted sufficient protection for abuses such as those of the Labor Finance Industrial Bank. Accordingly, the limitation imposed on banks by Congress was limited to a bank's consumer credit function rather than including the bank's trustee function as well. In fact, Congress was well aware in 1976 that banks made student loans in both their own capacity and as trustee on behalf of trust funds, since in 1965 Congress had expressly authorized lenders to make GSLP loans from trust funds. See 20 U.S.C. § 1076. Thus, despite the fact that Congress imposed limitations on a bank's own extensions of consumer credit for GSLP loans, Congress's omission of an express limitation on loans made as part of a lender's trustee function, coupled with its omission of any limitation on pension fund lending, can be reasonably interpreted as an indication of Congress' intention to place no limitation on GSLP lending by trust funds. This would be true regardless of whether a bank or a pension fund is the trustee.

In response to your Department's broad-based criticisms FITCO has been required at great expense to seek and obtain independent counsel from numerous firms with special expertise in the areas of state and federal banking laws, the laws of trusts, student loan programs and state and federal regulatory laws. It will suffice to say here that counsel intimately familiar with federal banking laws and lawmaking have independently considered the question, and have confirmed the conclusions stated herein. In summary, it seems quite clear that a trust bank investing trust assets in GSLP loans pursuant to 20 U.S.C. Section 1076 is not engaged in the "primary consumer credit function" contemplated by Section 1085(g)(1)(A), since the institution has no equity of its own invested and hence is in the same position as pension trustees who are not subject to any similar limitation under Section 1085(g)(2).

Branch Application and Report of Examination

I assume that the reference in your counsel's letter to your intention to deny FITCO's branch application does not constitute a final action upon that application and that your decision has not been made prior to a reasoned resolution of the disputed "contingent liabilities" fabricated from nonexistent breaches of trust duties. If those erroneous concerns are the sole reason for threatening to deny that application, I suggest that the foregoing responses render such a denial highly inappropriate and speculative.

A separate response to the Report of Examination is currently being prepared by FITCO. One point relevant to the discussion herein as to trust confidentiality, however, is that

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your counsel's demand that "Assets should be held as 'trustee for' rather than as owner or beneficiary," is an improper and unauthorized demand.

In our meeting January 16, I posed a question, which I shall posit here once again: Does the State Banking Department take the position that the trust business in which FITCO is authorized to engage is any different from that authorized as to trust departments of departmental banks? I did not receive a satisfactory answer at the time and thought you may wish to inquire into that issue yourself. It is my perception that possibly a double standard exists, resulting in persistent discriminatory treatment of FITCO, because your staff has never applied similarly intensive scrutiny to the trust departments of other banks.

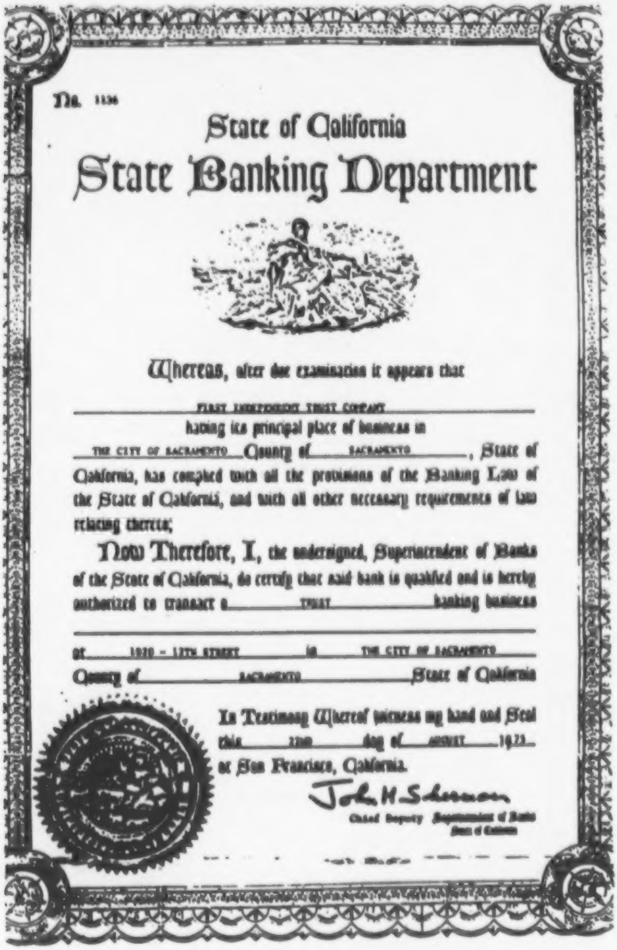
FITCO has been patient and responsive in the face of uninformed criticisms and unwarranted threats. Substantial documentation revisions are proposed, advertisements have been withdrawn, trust operations have been revised. Substantial financial, legal and managerial resources have been diverted at great expense in order to respond to charges that should never have been made. Unauthorized administrative interference in the contractual and statutory freedoms of trustors and trustees, however, simply cannot be accepted. Please consider carefully the reasonableness of FITCO's intentions as expressed herein as to future operations, and please consider the probability that in at least some respects, your staff are simply wrong. Naturally we would welcome thu opportunity to discuss these matters personally with you and your staff.

Very truly yours,

Jon Smock

JON D. SMOCK

Enclosures
JDS/mc



No. 1136

State of California

State Banking Department

Whereas, after due examination it appears that

FIRST INDEPENDENT TRUST COMPANY

having its principal place of business in

THE CITY OF SACRAMENTO County of SACRAMENTO, State of California, has complied with all the provisions of the Banking Law of the State of California, and with all other necessary requirements of law relating thereto;

Now Therefore, I, the undersigned, Superintendent of Banks of the State of California, do certify that said bank is qualified and is hereby authorized to transact a TRUST banking business

at 1020 - 12TH STREET in THE CITY OF SACRAMENTO

County of SACRAMENTO State of California

In Testimony Whereof witness my hand and Seal this 22ND day of AUGUST 1973 at San Francisco, California.

John H. Schneman

Chief Deputy Superintendent of Banks
State of California

Form 140 (Revised 11-76)
Calif. State Banking Dept.

Bank Number 1135

Examination Date August 31, 1985

State of California

BANKING DEPARTMENT

REPORT OF EXAMINATION

First Independent Trust Company

Sacramento, CA

EXAMINER-IN-CHARGE Arlene F. Byers

THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL

This report of examination has been made by an examiner appointed by the State Banking Department of the State of California for use in the supervision of the bank. This copy of the report is the property of the State Banking Department, State of California and is furnished to the bank examined for its confidential use. Under no circumstances shall the bank, or any of its directors, officers, or employees disclose or make public in any manner the report or any portion thereof.

The information contained in this report is based upon the books and records of the bank, upon statements made to the Examiner by directors, officers, and employees, and upon information obtained from other sources believed to be reliable and presumed by the Examiner to be correct.

It is recommended that each director, in keeping with his responsibilities both to depositors and to shareholders, thoroughly review the report. In making this review, it should be kept in mind that an examination is not the same as an audit, and this report should not be considered to be an audit report.

EXHIBIT 2

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EXHIBIT 3

ACCOUNT NAME ACCOUNT NO.

The undersigned agree(s) with **RiverCityBank** ("Bank")

that this account shall be carried by Bank as a ☒ CHECKING ☐ SAVINGS account and that the undersigned shall be bound by, and that said account and all transactions in connection therewith shall be subject to, all by-laws, regulations and service, interest and other rules and practices of Bank relating to said account now in effect or hereafter adopted. Subject to the terms hereof, this agreement shall be governed by the law of the State and, to the extent applicable to Bank, the national banking laws. The undersigned authorize(s) Bank to Mail or hold statements, vouchers and notices as indicated on reverse hereof. The undersigned further agree(s) that all funds now on deposit or which hereafter may be placed on deposit in said account shall be the property of the undersigned as

☐ INDIVIDUAL. ☐ TRUSTEE (*See Beneficiary Identification attached, if applicable*).

☒ JOINT TENANTS, who agree that (a) funds may be withdrawn or paid upon the number of signatures indicated below, or to the survivor(s), except that in the event of conflicting demands of the undersigned, Bank may require all signatures of the undersigned; (b) in the event of the death of any of the undersigned the survivor(s) will notify Bank at once; (c) in the event that said account shall be overdrawn as a consequence of checks drawn or withdrawals made as provided herein, the undersigned jointly and severally agree to reimburse Bank for such overdrafts, regardless of the manner in which or by whom the same may have been caused; and (d) Bank may accept and cash, or deposit to said account, all checks payable to any or all of the undersigned when endorsed by any of them, or one for the other.

Number of signatures required to withdraw funds ____________

PLEASE SIGN

1. X ____

2. X ____

INDIVIDUAL, TRUSTEE OR JOINT TENANCY SIGNATURE CARD
NA 206

(Over)

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DECLARATION OF DIRECTORY TRUST

A/C________

Trustor (I):____

Trustee (You): FIRST INDEPENDENT TRUST COMPANY

Without consideration, other than your promises in this Declaration, I transfer to you, and you acknowledge receipt of, $________, IN TRUST, to be used as follows. I may revoke this Trust, in whole or in part, by giving you a thirty day written notice. I may amend this Trust or any addendum thereto in writing with your written consent. This Trust shall terminate upon my death or upon 30 day written notice by you.

I direct you to invest and reinvest the funds available in my Trust in identifiable guaranteed, insured, or full faith and credit obligations of The United States, including securities eligible for the investment of surplus State moneys as provided in California Government Code 16430(j). You may sell or exchange any Trust investments. Upon termination of this Trust, in whole or in part, you shall convert its assets into cash and distribute the proceeds to me, or if termination results from my death, the person entitled to my property.

I understand that the income from these investments is based upon the discount rate of U.S. Treasury Bills and is indefinite. You shall distribute to me quarterly by cash, or addition to my Trust, as I instruct in writing, on the fifth business day of the first month of the quarter succeeding that in which you receive income for my Trust an amount which is equal to 3.5 percent over the average 91-day Treasury Bill weekly auction rate during the preceding quarter, less (a) 2.5% on accounts of $2,500 to $49,999; (b) 2% on accounts of $50,000 or more.

I further understand that for administrative purposes, funds awaiting investment may be held briefly in insured accounts earning a rate of interest different from 3.5 percent over the average 91-day Treasury Bill weekly auction rate. I agree and understand that your fee for the administrative services of my Trust shall be all income earned on Trust assets in excess of the payments specified above. I specifically waive any accounting by you to me for the income actually earned on my said assets. I also understand that when you sell assets from my Trust you are entitled to compensation from the purchaser for your services in assembling and providing supporting documentation in the amount of one percent of the unpaid balance of the obligations sold. I specifically agree to your receiving such compensation.

I authorize you to hold title to obligations purchased for my Trust in your name. I understand that, to retain their guaranteed, reinsured or full faith and credit status, certain obligations in which [illegible] invest for my Trust must, by law, be held in your name as an eligible lender approved by The United States. You shall maintain records of my Trust investments and distributions due me as above specified in a simplified accepted bookkeeping fashion.

The funds which I transfer to you for my Trust are to be held and administered by you in accordance with California Trust law, except as otherwise provided herein, and not in a depositary debtor-creditor relationship. I certify that I have full capacity to contract, that I have read and fully understand this Declaration, and that I have entered into it of my own free will and without inducement other than my desire to obtain the benefit of the income from the investments of which I may receive the distributions to which I have hereby agreed. Executed this ____day of __________,19__.

FIRST INDEPENDENT TRUST COMPANY,
Trustee

By:______________________________
Authorized Signature

____
Trustor

____
Trustor

EXHIBIT 4

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TRUST AGREEMENT

This agreement is entered into as of ______________________ (Date) by and between:

GRANTOR	TRUSTEE
Owner/Operator Name:	Trustee Name:
Address:	Address:
☐ Corporation ☐ Association ☐ Partner ☐ Proprietorship In the State of ______________________	☐ Incorporated in the State of ______________ ☐ A National Bank

TERMS OF AGREEMENT

WHEREAS, the Department of Health Services (DHS), a department of the State of California, has established certain regulations applicable to the Grantor, requiring that an owner or operator of a hazardous waste management facility shall provide assurance that funds will be available when needed for closure and/or post-closure care of the facility.

WHEREAS, the Grantor has elected to establish a trust to provide all or part of such financial assurance for the facilities identified herein.

WHEREAS, the Grantor, acting through its duly authorized officers, has selected the trustee to be the trustee under this agreement, and the Trustee is willing to act as trustee.

NOW, THEREFORE, the Grantor and Trustee agree as follows:

Section 1. Definitions. As used in this Agreement:

(a) The term "Grantor" means the owner or operator who enters into this Agreement and any successors or assigns of the Grantor.

(b) The term "Trustee" means the Trustee who enters into this Agreement and any successor Trustee.

(c) The term "Beneficiary" means State of California, Department of Health Services.

Section 2. Identification of Facilities and Cost Estimates. This Agreement pertains to the facilities and cost estimates identified on attached Schedule A [on Schedule A – for each facility list the hazardous waste facility identification number, name, address, and the current closure and/or post-closure cost estimates (indicate the closure and post-closure amounts separately), or portions thereof, for which financial assurance is demonstrated by this Agreement].

Section 3. Establishment of Fund. The Grantor and the Trustee hereby establish a trust fund, the "Fund," for the benefit of the Beneficiary. The Grantor and the Trustee intend that no third party have access to the Fund except as herein provided. The Fund is established initially as consisting of the property, which is acceptable to the Trustee, described in Schedule B attached hereto. Such property and any other property subsequently transferred to the Trustee is referred to as the Fund, together with all earnings and profits thereon, less any payments or distributions made by the Trustee pursuant to this Agreement. The Fund shall be held by the Trustee, IN TRUST, as hereinafter provided. The Trustee shall not be responsible nor shall it undertake any responsibility for the amount or adequacy of, nor any duty to collect from the Grantor, any payments necessary to discharge any liabilities of the Grantor established by the Beneficiary.

Section 4. Payment for Closure and Post-Closure Care. The Trustee shall make payments from the Fund as Beneficiary shall direct, in writing, to provide for the payment of the costs of closure and/or post-closure care of the facilities covered by this Agreement. The Trustee shall reimburse the Grantor or other persons as specified by the Beneficiary from the Fund for closure and post-closure expenditures in such amounts as Beneficiary shall direct in writing. In addition, the Trustee shall refund to the Grantor such amounts as Beneficiary specifies in writing. Upon refund, such funds shall not constitute part of the Fund as defined herein.

Section 5. Payments Comprising the Fund. Payments made to the Trustee for the Fund shall consist of cash or securities acceptable to the Trustee.

EXHIBIT 5.1

Section 6. Trustee Management. The Trustee shall invest and reinvest the principal and income of the Fund and keep the Fund invested as a single fund, without distinction between principal and income, in accordance with general investment policies and guidelines which the Grantor may communicate in writing to the Trustee from time to time, subject, however, to the provisions of this Section. In investing, reinvesting, exchanging, selling and managing the Fund, the Trustee shall discharge his or her duties with respect to the trust fund solely in the interest of the Beneficiary and with the care, skill, prudence and diligence under the circumstances then prevailing which persons of prudence, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character and with like aims, except that:

(i) Securities or other obligations of the Grantor, or any other owner or operator of the facilities, or any of their affiliates as defined in the Investment Company Act of 1940, as amended, 15 U.S.C. 80a 2 (a), shall not be acquired or held, unless they are securities or other obligations of the Federal or State Government.

(ii) The Trustee is authorized to invest the Fund in time or demand deposits of the Trustee, to the extent insured by an agency of the Federal or State Government; and

(iii) The Trustee is authorized to hold cash awaiting investment or distribution uninvested for a reasonable time and without liability for the payment of interest thereon.

Section 7. Commingling and Investment. The Trustee is expressly authorized in its discretion:

(a) To transfer from time to time any or all of the assets of the Fund to any common, commingled or collective trust fund created by the Trustee in which the Fund is eligible to participate, subject to all of the provisions thereof, to be commingled with the assets of other trusts participating therein; and

(b) To purchase shares in any investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., including one which may be created, managed, underwritten or to which investment advice is rendered or the shares of which are sold by the Trustee. The Trustee may vote such shares in its discretion.

Section 8. Express Powers of Trustee. Without in any way limiting the powers and discretions conferred upon the Trustee by the other provisions of this Agreement or by law, the Trustee is expressly authorized and empowered:

(a) To sell, exchange, convey, transfer or otherwise dispose of any property held by it, by public or private sale. No person dealing with the Trustee shall be bound to see to the application of the purchase money or to inquire into the validity or expediency of any such sale or other disposition;

(b) To make, execute, acknowledge and deliver any and all documents of transfer and conveyance and any and all other instruments that may be necessary or appropriate to carry out the powers herein granted;

(c) To register any securities held in the Fund in its own name or in the name of a nominee and to hold any security in bearer form or in book entry, or to combine certificates representing such securities with certificates of the same issue held by the Trustee in other fiduciary capacities, or to deposit or arrange for the deposit of such securities in a qualified central depository even though, when so deposited, such securities may be merged and held in bulk in the name of the nominee of such depository with other securities deposited therein by another person, or to deposit or arrange for the deposit of any securities issued by the United States Government, or any agency or instrumentality thereof, with a Federal Reserve bank, but the books and records of the Trustee shall at all times show that all such securities are part of the Fund;

(d) To deposit any cash in the Fund in interest-bearing accounts maintained or savings certificates issued by the Trustee, in its separate corporate capacity, or in any other banking institution affiliated with the Trustee, to the extent insured by an agency of the Federal or State Government; and

(e) To compromise or otherwise adjust all claims in favor of or against the Fund.

Section 9. Taxes and Expenses. All taxes of any kind that may be assessed or levied against or in respect of the Fund and all brokerage commissions incurred by the Fund shall be paid from the Fund. All other expenses incurred by the Trustee in connection with the administration of this Trust, including fees for legal services rendered to the Trustee, the compensation of the Trustee to the extent not paid directly by the Grantor, and all other proper charges and disbursements of the Trustee shall be paid from the Fund.

EXHIBIT 5.2

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Section 10. Annual Valuation. The Trustee shall annually, at least 30 days prior to the anniversary date of establishment of the Fund, furnish to the Grantor and to Beneficiary a statement confirming the value of the Trust. Any securities in the Fund shall be valued at market value as of no more than 60 days prior to the anniversary date of establishment of the Fund. The failure of the Grantor to object in writing to the Trustee within 90 days after the statement has been furnished to the Grantor and Beneficiary shall constitute a conclusively binding assent by the Grantor, barring the Grantor from asserting any claim or liability against the Trustee with respect to matters disclosed in the statement.

Section 11. Advice of Counsel. The Trustee may from time to time consult with counsel, who may be counsel to the Grantor, with respect to any question arising as to the construction of this Agreement or any action to be taken hereunder. The Trustee shall be fully protected, to the extent permitted by law, in acting upon the advice of counsel.

Section 12. Trustee Compensation. The Trustee shall be entitled to reasonable compensation for its services as agreed upon in writing from time to time with the Grantor.

Section 13. Successor Trustee. The Trustee may resign or the Grantor may replace the Trustee, but such resignation or replacement shall not be effective until the Grantor has appointed a successor trustee and this successor accepts the appointment. The successor trustee shall have the same powers and duties as those conferred upon the Trustee hereunder. Upon the successor trustee's acceptance of the appointment, the Trustee shall assign, transfer and pay over to the successor trustee the funds and properties then constituting the Fund. If, for any reason, the Grantor cannot or does not act in the event of the resignation of the Trustee, the Trustee may apply to a court of competent jurisdiction for the appointment of a successor trustee or for instructions. The successor trustee shall specify the date on which it assumes administration of the trust in a writing sent to the Grantor, Beneficiary, and the present Trustee by certified mail ten days before such change becomes effective. Any expenses incurred by the Trustee as a result of any of the acts contemplated by this Section shall be paid as provided in Section 9.

Section 14. Instructions to the Trustee. All orders, requests and instructions by the Grantor to the Trustee shall be in writing, signed by such persons as are designated in the attached Exhibit A or such other designees as the Grantor may designate by amendment to Exhibit A. The Trustee shall be fully protected in acting without inquiry in accordance with the Grantor's orders, requests and instructions. All orders, requests and instructions by the Beneficiary to the Trustee shall be in writing, signed by the Beneficiary designees, and the Trustee shall act and shall be fully protected in acting in accordance with such orders, requests and instructions. The Trustee shall have the right to assume, in the absence of written notice to the contrary, that no event constituting a change or a termination of the authority of any person to act on behalf of the Grantor or the Beneficiary hereunder has occurred. The Trustee shall have no duty to act in the absence of such orders, requests and instructions from the Grantor and/or Beneficiary, except as provided for herein.

Section 15. Notice of Nonpayment. The Trustee shall notify the Grantor and the Beneficiary, by either registered or certified mail within 10 days following the expiration of the 30-day period after the anniversary of the establishment of the Trust, if no payment is received from the Grantor during that period. After the pay-in period is completed, the Trustee shall not be required to send a notice of nonpayment.

Section 16. Amendment of Agreement. This agreement may be amended by an instrument in writing executed by the Grantor, the Trustee and the Beneficiary, or by the Trustee and the Beneficiary, if the Grantor ceases to exist.

Section 17. Irrevocability and Termination. Subject to the right of the parties to amend this Agreement as provided in Section 16, this Trust shall be irrevocable and shall continue until terminated at the written agreement of the Grantor, the Trustee, and the Beneficiary, or by the Trustee and the Beneficiary, if the Grantor ceases to exist. Upon termination of the Trust, all remaining trust property, less final trust administration expenses, shall be delivered to the Grantor.

Section 18. Immunity and Indemnification. The Trustee shall not incur personal liability of any nature in connection with any act or omission, made in good faith, in the administration of this Trust, or in carrying out any directions by the Grantor or the Beneficiary issued in accordance with this Agreement. The Trustee shall be indemnified and saved harmless by the Grantor or from the Trust Fund, or both, from and against any personal liability to which the Trustee may be subjected by reason of any act or conduct in its official capacity, including all expenses reasonably incurred in its defense in the event the Grantor fails to provide such defense.

EXHIBIT 5.3

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Section 19. Choice of Law. This Agreement shall be administered, construed and enforced according to the laws of the State of California.

Section 20. Interpretation. As used in this Agreement, words in the singular include the plural and words in the plural include the singular. The descriptive headings for each Section of this Agreement shall not affect the interpretation or the legal efficacy of the Agreement.

IN WITNESS WHEREOF the parties have caused this Agreement to be executed by their respective officers duly authorized and their corporate seals to be hereunto affixed and attested as of the date first above written: The parties below certify that this document is being executed in accordance with the requirements of Article 17, Title 22, California Administrative Code.

Signature of Grantor: ▶	Title:
Typed or Printed Name of Person Signing:	Seal:
Attest: Title	
Signature of Trustee: ▶	Title:
Typed or Printed Name of Person Signing:	Seal:
Attest: Title	

PRIVACY STATEMENT

This information is requested by the Department of Health Services, Toxic Substances Control Division, under Health and Safety Code, Section 25245 in order to verify adequate financial assurance of Hazardous Waste Facilities. Completion of the form is mandatory. The consequence of not completing the form is denial of a permit to operate a hazardous waste facility. Information may be provided to U. S. Environmental Protection Agency (EPA), State Attorney General, Air Resources Board, California Waste Management Board, Energy Resources Conservation and Development Commission, Water Resources Control Board and California Regional Water Quality Control Boards. For more information or access to your records, contact the Toxic Substances Control Division, 714 P Street, Sacramento, CA 95814, (916) 324-1826.

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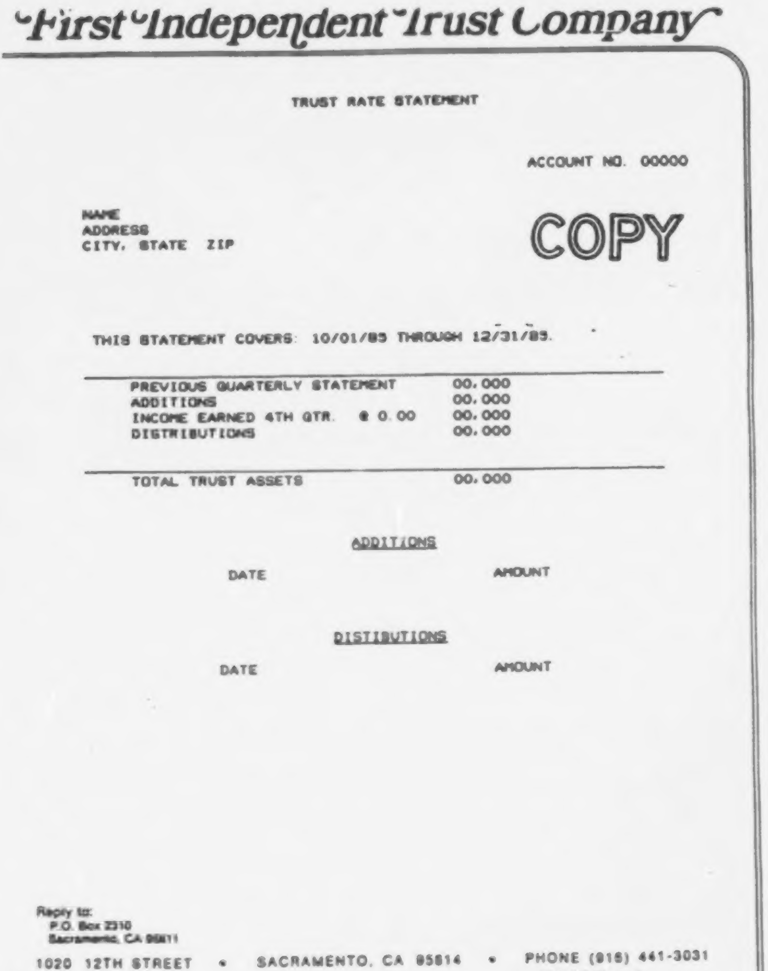

First Independent Trust Company

TRUST RATE STATEMENT

ACCOUNT NO. 00000

NAME
ADDRESS
CITY, STATE ZIP

COPY

THIS STATEMENT COVERS: 10/01/85 THROUGH 12/31/85.

PREVIOUS QUARTERLY STATEMENT	00,000
ADDITIONS	00,000
INCOME EARNED 4TH QTR. @ 0.00	00,000
DISTRIBUTIONS	00,000
TOTAL TRUST ASSETS	00,000

ADDITIONS

DATE	AMOUNT

DISTIBUTIONS

DATE	AMOUNT

Reply to:
P.O. Box 2310
Sacramento, CA 95811

1020 12TH STREET • SACRAMENTO, CA 95814 • PHONE (916) 441-3031

EXHIBIT 6.1

01/27/86 FIRST INDEPENDENT TRUST CORPORATION PAGE :

STATEMENT OF STUDENT LOAN INVESTMENT

Account No.	Tax I.D.	Beginning Balance
022111	570-40-7463	$ 51,152.76

Loan SSN	Disbursed	Amount	Allocated
412-74-1079	01/07/86	3,000	01/27/86
558-08-2635	10/21/85	2,500	01/27/86
558-08-6948	01/07/86	2,500	01/27/86
558-08-7239	01/19/86	2,500	01/27/86
558-11-7441	07/19/85	2,500	01/27/86
558-13-1969	01/22/86	2,500	01/27/86
558-13-2098	01/25/86	2,500	01/27/86
558-15-3879	12/14/85	2,500	01/27/86
558-17-3924	01/22/86	2,500	01/27/86
558-17-6683	10/30/85	2,500	01/27/86
558-17-7539	01/14/86	2,500	01/27/86
558-19-0533	01/22/86	2,500	01/27/86
558-19-2426	01/22/86	2,500	01/27/86
558-19-5292	01/26/86	2,500	01/27/86
558-19-8829	01/26/86	2,500	01/27/86
558-21-8042	01/26/86	2,500	01/27/86
558-23-5630	01/21/86	2,500	01/27/86

	NO OF LOANS	TOTAL AMOUNT	BALANCE IN OTHER INVESTMENTS
Subtotal for Account	17	$43,000	$ 8,152.76

EXHIBIT 6.2

APPENDIX

U. S. CODE DEFINITION OF BANKS

26 U.S.C. § 581:

Definition of bank

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association. . . .

15 U.S.C. § 78c(a)(6):

The term "bank" means: . . . Any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks. . . .

15 U.S.C. § 80b-2(a)(2):

"Bank" means: . . . any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks. . . .

15 U.S.C. § 80a-2(a)(5):

"Bank means . . . any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks. . . .

EXHIBIT 7.1

26 U.S.C. § 408(n):

(a) Bank. For purposes of subsection (a)(2), the term "bank" means--
(1) any bank (as defined in section 581 [26 USC § 581]),
(2) an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act [12 USC § 1752], and
(3) a corporation which, under the laws of the State of its incorporation, is subject to supervision and examination by the Commissioner of Banking or other officer of such State in charge of the administrations of the banking laws of such State.

15 U.S.C. § 77c(a)(2):

. . . the term "bank" means any national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940 [15 USC § 80-a-2].

18 U.S.C. § 2113(f):

As used in this section the term "bank" means any member bank of the Federal Reserve System, and any bank, banking association, trust company, savings bank, or other banking institution organized or operating under the laws of the United States, and any bank the deposits of which are insured by the Federal Deposit Insurance Corporation.

12 U.S.C. § 36(h):

(h) The words "State bank," "State banks," or" banks," as used in this section, shall be held to include trust companies, savings banks, or other such corporations or institutions carrying on the banking business under the authority of State laws.

12 U.S.C. § 202:

As used in this subchapter, the term "bank" means (1) any national banking association, and (2) any bank or trust company located in the District of Columbia and operating under the supervision of the Comptroller of Currency; . . . .

12 U.S.C. § 371c(b)(5):

(5) the term "bank" includes a State bank, national bank, banking association, and trust company; . . . .

12 U.S.C. § 3101(13):

(13) The term "bank", "bank holding company", "company", "control", and "subsidiary" have the same meanings assigned to those terms in the Bank Holding Company Act of 1956, ...

12 U.S.C. § 221:

Whenever the word "bank" is used in this chapter, the word shall be held to include State bank, banking association, and trust company, except where national bank or Federal reserve banks are specifically referred to.

12 U.S.C. § 27(a):

[A] National Banking Association, to which the Comptroller (issues a charter) is not illegally consitituted solely because its operations are or have been required by the Comptroller to be limited to those of a trust company . . . ."

EXHIBIT 7.3

LAW OFFICES OF
GREVE, CLIFFORD, DIEPENBROCK & PARAS
1000 G STREET, SUITE 400
POST OFFICE BOX 2469
SACRAMENTO, CALIFORNIA 95811-2469
(916) 443-2011

[illegible]
ANTHONY C. DIEPENBROCK
GERARD A. ROSE
GORDON A. COOK
THOMAS L. KNOX
GARY L. LIVESON
GARY SCOTT DECKER
DENNIS W. RICHARDSON
JOHN M. LEMMON
BRADLEY R. LARSON
SUSAN J. SHERIDAN
MAUREEN A. FALCONER
ANNETTE P. BELOLE
ROBERT L. COLLINS
PAUL E. ABONG
JANET HALLOX

EDWARD T. CLIFFORD
GEORGE E. PARAS
LAWRENCE A. WENGEL
WILLIAM C. BARRY
RICHARD L. MANFORD
LOUIS J. ANATOLSKY
E. EARL SECHRIST III
JEALYN PAIK
ROBERT K. POLLAK
PAMELA A. BABICH
DANIEL F. COSTA
LINDSAY R. BRACK
WILLIAM L. BAKER
DANAE A. PARAS
WILLIAM H. POE
CORIN L. KAHN

[illegible]

March 19, 1986
(hand delivered)

PERSONAL

Mr. Deno Evangelista
c/o First Independent Trust Comp ny
1020 12th Street
Sacramento, CA 95814

RE: State Banking Department

Dear Mr. Evangelista:

Several weeks ago you conferred with me concerning the subject matter encompassed in a formal letter dated January 10, 1986 from the State Banking Department to you in your capacity as Chairman of the Board of First Independent Trust Company. You asked me to study the matter, doing whatever independent research I felt appropriate, but specifically focusing upon the Department's letter of January 10th, your lawyer's reply letter of February 17th, and a number of other letters sent to you by persons qualified to give opinions regarding your institution (FITCO).

A starting point in my own report to you might be the eight topics specified on the first and second pages of the Department's January 10th letter. I don't, however, find all of them appropriate because, for example, number 7, "FITCO's branch application cannot be approved", is not really a topic inviting comment. All I can say about that is that the Department jumped to conclusion after conclusion regarding your trust activity, all adverse to FITCO, progressed from there to a belief that there are "potentially great contingent liabilities", and ultimately reached the conclusion that the application must be denied. Since obviously it is your position, which I fully support, that all the condemnatory conclusions reached by the Department against FITCO are wholly inappropriate, I necessarily disagree with the conclusion, but do not feel that I should deal with it as a separate topic.

EXHIBIT C

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The first six enumerated topics can and will be dealt with by me. They are as follows:

1. Is FITCO a Commercial Bank?
2. Are FITCO's "trust rate savings accounts" commercial banking business?
3. Should FITCO eliminate from its trust agreements all references to "bank", "savings accounts", or "deposits"?
4. Should FITCO make full disclosure immediately to its beneficiaries?
5. Is FITCO's currently proposed trust agreement appropriate?
6. Is FITCO an eligible lender?

I could easily answer all of these by reference simply to Jon D. Smock's (your lawyer) letter of February 17th to the Department, replying point by point to each of the eight enumerated items. As you know, I have been in this business a lot of years and more times than I could ever count have been required to evaluate legal briefs and arguments; unequivocally I can say that I have never encountered a more thoroughly competent refutation of unwarranted charges than that contained in the Smock letter. It is obvious that he analyzed clearly and thoroughly all aspects of the problem, both from the technically legal standpoint and from the practical day-to-day working standpoint; it is also clear that he relied heavily on outside competent and thorough analysis and legal opinion rendered to you by other lawyers whose experience, training, and current practice give them the best available expertise with which to render opinions on the subject. These opinions have been interpolated into Smock's February letter in such a way as to bring about a thorough refutation of the Department's charges, hopefully with the result that the Department will review its earlier conclusions and recognize your point of view.

It is to be hoped that what the Smock letter did not produce (yet), this letter to you will help produce, a recognition by the Department that FITCO's activities with regard to student loans have not been and will never be deceptive, illegal, or in any way improper or inappropriate.

1. FITCO is not a Commercial Bank. This topic was covered thoroughly in Mr. G's letter to you of February 5, 1986, Ms. W's letter of January 9, 1986, and in Mr. Smock's letter, which used extensively the information supplied by Mr. G and Ms. W.

Of course FITCO is not a Commerical Bank. No one says it is and no one has ever disputed that it is not. But the issue as posited in the Department's January 10th letter really does not make any sense in any condemnatory context. The contention might just as accurately and easily say "FITCO is not a real estate broker." The true underlying claim of the Department is not genuinely enunciated in its paragraph one, but rather its paragraph three, for its true contention is that FITCO is not a "bank", in other words not a bank at all. Looked at from that point of view, I can only refer you to your two super highly-qualified experts and their letters described above, along with the very thorough and analytical explanations supplied by Mr. Smock. For my own purposes, and for purposes of any intelligent and neutrally-minded person reading a statute, all that is necessary on this issue is a reading of the first sentence in Financial Code Section 102: "The word 'bank' as used in this division means any incorporated banking institution which shall have been incorporated to engage in commercial banking business or trust business."

FITCO, under the laws pursuant to which it was chartered, has always been and is a "bank".

2. FITCO's "trust rate savings accounts" are Commercial Banking Business. They are not, either in the lay understanding of the term or in the statutorily defined meaning. Again, as fortified by Mr. G's letter, the Smock letter has fully and completely answered and analyzed this question. It is stretching the interpretation of statutes to its breaking point to assert the position of the Department. The word "account" does not connote to a layperson the pre-existence of a bank. My wife has an account with Magnin's or Penney's -- she never conceives of it as a bank account. I have an account with Paine-Weber -- that is not a bank account. A "trust account" is a commonly used term to include in a layperson's mind both the form of account at a bank and also a form of account with a lawyer, real estate broker, or other fiduciary. And finally, the term "trust rate savings accounts", in the context in which FITCO used the term, could not possibly connote to the trustor either the existence of a bank account relationship between FITCO and the trustor, or that FITCO was engaged in commercial banking. All the factual material unerringly points to an absence of confusion in this regard and an inappropriate claim to some sort of impropriety in using the term "trust rate savings accounts".

In any event, I have seen and studied the new draft of "Declaration of Directory Trust", which was specially prepared for you by Mr. R and transmitted by his letter of January 6, 1986. This declaration cannot be argued by anyone to either involve the use of the offensive (to the Department) term or even be remotely suggestive of any Commercial Banking Business being involved. I believe that you have supplied the Department with this new trust form, which is not at all the one condemned in the Department's paragraph five. I am reasonably certain that the Department has found this form acceptable so that it takes care of both item number two and item number five.

3. FITCO must immediately cease accepting funds in the Trust Rate Program and stop all references to "bank", "savings account" or "deposits". As you observe, this point has two parts. First, FITCO is asked to cease accepting funds in the Trust Rate Program at all, and second, cease using the words bank, savings account or deposit. Let's take the first. It is the equivalent of telling you to go out of the trust business, which is precisely what you were chartered to do. How can you be in the trust business and not accept funds? How can you be a trust company and not have one or more trust programs, with specific designations? What is the matter with the term "trust rate" as applied to a type of trust? I really can't believe the Department seriously intends this, but will move on to the second subheading.

The Department wants you to stop all references to "bank", "savings accounts", or "deposits". I recognize that even though no one of your advisers has suggested any impropriety with "savings accounts" or "deposits", you are willing to eliminate their use; and in fact, I find neither of those words in your new Declaration of Directory Trust form. Since you have conceded it for purposes of attempting to cooperate with the Department's wishes, I should not dwell on it. But I cannot help but remark that the way FITCO used those terms in connection with its student loan program and the trusts involving it, there was no vestige of deception or confusion. The references were completely innocuous and if used as they were originally used by you for the next 50 years, I cannot conceive of a single person executing a trust agreement with the misunderstanding.

The real horror of the Department's contention number three is its insistence that you not refer to yourself as a "bank". What in the hell else are you but a bank? You were chartered as a bank. You are defined by California laws as a bank. I thoroughly read and digested the detailed reasons enunciated by the Department both in its January 10th letter and its earlier October 31, 1985 letter, and I find its logic incredulous. The Department's own analysis facially denies its conclusion. On page three of its January 10th letter, the Department tells us in part: "Banks are divided into the following classes: (a) Commercial banks; (b) Trust companies", quoting specifically from Financial Code Section 103. Then it goes on to define a "commercial bank" under Section 105, and thereafter reaches the incredible non sequitur that FITCO is not a bank

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because it is not a Commercial Bank. I am getting repetitious, because this was covered so thoroughly in the outside opinions referred to above and in Smock's letter, but I really find myself a bit frustrated.

Perhaps the problem can be explained this way. For some reason, which I have trouble understanding, the Department may have concluded that trust companies as a separate entity are an anachronism just as "savings banks", and therefore should either be eliminated or treated under a separate set of laws and regulations. If such were the case, I could respect such a determination, even though I do not agree with it, having seen or experienced no abuses of the system under which we have operated for so many years. But if that were the case, then it would be understandable for the Department, if it were proposing a completely new change in the law, to make the kind of distinction it pursues in its January 10th letter. But it cannot make the philosophical, political, or socially scientific conclusion to that effect, then seek to thrust it into existing law which is so clearly and expressly to the contrary. Yet that almost appears to be what the Department has done.

4. FITCO must immediately make full disclosure to existing "trust rate" Account Holders. Of course this should be done, now and always. And indeed it has been done. The disclosure takes the form of everything contained in the trust instrument, and I cannot find any lack of disclosure in any of the trust forms heretofore used. But certainly the last one prepared by Mr. R cannot be faulted for any deficiency in disclosure.

Now if by item four the Department means that somehow you should write some sort of affirmative letter of apology or something equally ridiculous and send it to all your trustors or beneficiaries, thereby making "full disclosure", that is out of the question. I am morally certain that the Department simply means by this that the trust instrument henceforth shall be sufficient, and to the extent that you have determined to use the new trust agreement form, it should be executed and substituted for any pre-existing form with current trustors and beneficiaries.

5. As indicated above, I don't believe the Department's letter of January 10th refers to the same trust agreement as was prepared for you by Mr. R. It is therefore of no value for me to pursue this any further.

6. FITCO does not appear to qualify as an Eligible Lender. This is a wholly inappropriate conclusion for the Department to reach in light of the Federal enactments. Mr. Smock's very thorough response need not be reiterated by me here, except to

state that I have read thoroughly the independent legal opinion dated January 31, 1986 from Mr. N which expertly and thoroughly analyzes the subject. FITCO unequivocally is an Eligible Lender under Federal law.

Perhaps this letter turned out longer than expected. I really had intended only to give you a brief review of my general impressions; I seem to have gotten very much involved in my subject. But in summary, I can only applaud the approach you have pursued up to this point. While disagreeing strongly with the Department, nonetheless, you have respected its views, considered them, obtained independent expert consultations regarding them, and replied to them most competently through your counsel. You even went substantially beyond this and conceded certain of their contentions, as for example, voluntarily eliminating any use of the words "accounts" or "deposit". You have revised your trust agreement form. You have done everything that an institution in your position could possibly do, in fairness to itself, to accommodate the wishes of the agency that regulates you.

But you can do no more. If literally you accepted each of [illegible] eight contentions of the Department, you simply would go out of business. Perhaps that is not precisely what the Department intended, but that is the practical effect of its claims.

[illegible] concluding advice to you is that you present yourself, directly or through your attorney, to the Director and make it clear [illegible] you have done everything you can possibly do, will consider suggestions for further changes, but you will not consider under any circumstances removing your institution from trust business involving student loans. More specifically, there is no way you will stop calling yourself a bank when we all know you are a bank.

Sincerely yours,

GEORGE E. PARAS

GEP/jw

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STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor
CALIFORNIA STUDENT AID COMMISSION
1410 FIFTH STREET
SACRAMENTO, CA 95814 (916) 323-0438

June 16, 1986

Mr. Louis Carter
Superintendent of Banks
State Banking Department
235 Montgomery Street Suite 750
San Francisco, CA 94104-2980

Dear Mr. Carter:

I have received your June 10 letter.

As we discussed, our position has been and is that First Independent Trust Company is an eligible lender in our Educational Loan Programs by virtue of its status as a State chartered bank. It is our opinion that loans made from trust funds do not constitute "consumer loans" relative to program eligibility provisions.

We do agree that any question you have relative to the trust fund/consumer credit issue should be most directly resolved at the federal level, and that First Independent Trust should be the party to resolve the issue. If First Independent Trust does not provide you assurance that clarification will be sought, this agency will undertake an assessment of available alternatives to put the matter to rest.

If I can provide further assistance, please advise me.

Sincerely,

RICHARD E. REINHARDT
Deputy Director, Student Aid Commission
California Educational Loan Programs

U.S. DEPARTMENT OF EDUCATION
OFFICE OF POSTSECONDARY EDUCATION
50 UNITED NATIONS PLAZA - REGION IX
SAN FRANCISCO, CA 94102

OFFICE OF STUDENT
FINANCIAL ASSISTANCE

June 18, 1986

Mr. Jon D. Smock
General Counsel
First Independent Trust Company
Penthouse at the Forum
1107 Ninth Street
Sacramento, CA 95814

Dear Mr. Smock:

First Independent Trust Company became an eligible lender in the Guaranteed Student Loan Program on April 9, 1980 when they signed an agreement with the California Student Aid Commission. At that time it was determined they met the requirements of the Higher Education Act of 1965 as amended, Sections 426 and 435 (g)(1)(A). This eligibility remains in effect at this time.

Sincerely,

John H. Keefe
Chief
Guarantee Agency and
Lender Review Branch

EXHIBIT E

WEBSTER Career College

(213) 625-1205

207 South Broadway Los Angeles, California 90012

February 12, 1981

Mr. Deno Evangelista
President Chairman
First Independent Trust Company
1020 12th Street
Sacramento, California 95814

Dear Mr. Evangelista:

It was a pleasure visiting with you at your office in Sacramento.

As I told you during our conversation, the student body at Webster College is primarily composed of blacks and mexican-americans.

You'll be interested to know that we place over 90% of our graduates in jobs that start between $9,000.00 and $11,000.00 per annum, as shown by the records we are required to keep by the authorities.

However, most of these so called minority students find it impossible to obtain funding for the guaranteed student loans.

As you are aware the big banking institutions unjustly but cleverly avoid making loans to this type of applicants by requiring them or their families to have had a previous mutual banking relationship. Most of them have had none.

Other banks resort to devious excuses such as: "We make these loans only to sophomores with at least a 3 point average". That sounds like the story you told me: The Lady: "Hey Joe. Do you have cheap bananas?" Joe: "Yes, I have no cheap bananas".

As I told you during my visit I have travelled as far as Wyoming and even Washington, D. C. to try to obtain funding for my students. In other words getting "banking" for these minorities has been such a difficult and unfair problem that I was astonished and gratified to find that the First Independent Trust Co. represented by you, was willing to fund and indeed accepted the first group of applicants for the California Guaranteed Student Loan program regardless religion, social or economical background. May I thank you and commend you for your kind and intelligent decision. After all,

EXHIBIT F

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we tax payers would rather see a human being working, making money and paying taxes, than having him or her stay at home receiving a handout under the form of a monthly welfare check that comes indirectly from our own pockets.

So again, thank you so much Mr. Evangelista for helping build a stronger America by helping the disadvantadged minorities get the necessary skills to contributing group in our society.

I am also enclosing the list of the 15 students whose Guaranteed Loan Applications I left with you, and under separate cover I am sending the forms issued by your institution in which the borrower authorizes your firm to issue the proceeds of the loan in a check made jointly to the student and to Webster.

Respectfully yours,

Carlos Vega

Carlos Vega
President

csr
enclosure:

1 FIRST INDEPENDENT TRUST COMPANY
The INTRUST Bank
Chartered 1975

February 9, 1989

The Honorable Lauro Cavazos
Department of Education
Washington, D.C.

Dear Secretary Cavazos:

I am writing to you to acquaint you with the human tragedies and economic disasters that are continuing to build as the guaranteed student loan program continues to freeze out the Nation's vocational and technical school students.

As you may know, First Independent Trust Company has been one of the most prominent lenders to students of vocational and technical schools in the Nation. Unlike the big banks, we have not shunned the needs of the under-privileged who rely on such schools for a chance to share in the American dream. We have reached out at no small trouble and expense to serve those students' needs. Many years ago, I adopted the slogan "Education is the Safest Investment."

The recent collapse of the secondary market for such student loans, however, is totally drying up new funding for those students. Judging by the panicked communications we are receiving from students and schools, thousands and thousands of students are turning back to the streets uneducated and scores of schools are headed toward bankruptcy. Nor has our institution escaped this disaster. The sudden closure of secondary markets for vocational and technical student loans has abruptly absorbed the liquidity of funds which we administer and invest in student loans. A very substantial portion of our trust assets are tied up in a package routinely transmitted to the California Student Loan Finance Corporation (CSLFC). Because of the turmoil, CSLFC continues to tell us that they cannot consummate purchases because the Letter of Credit banks have drawn the purse strings closed. Without liquidity, we cannot write loans. And without loans, deserving students are returned to the streets.

We have for some time been the only lender available to many vocational, technical and community college students throughout the Nation. Not realizing all the causes at work, schools are lining up to sue us because we have had to reject their student's applications. A total collapse of educational opportunities for students other than those already fortunate to attend a four-year college is imminent. As you read this students who have been trying in vain since October and November for loans are giving up and going back to the streets, still uneducated and now more bitter.

....OVER....

EXHIBIT 6

MAIN OFFICE: 1020 12th Street, Post Office Box 2310 • Sacramento, CA 95811 • (916) 971-8800
STUDENT LOAN CENTER: 5325 Engle Road, Carmichael, Post Office Box 2562 • Sacramento, CA 95812 • (916) 971-8820

One chain of six or seven vocational schools, a good one by everything I know, has told me that they are going to have to close their doors unless we get their students some funding this week. We cannot do it without a viable secondary market. For want of anything else to do those schools and others will probably sue us. And because we are only a link in a larger chain, we will in turn be forced to sue everyone else in the chain. This cannot be good for the program or for your Department. And this won't do a bit of good for all those students out there who can't get the aid they need, the ones who need it most.

Something has got to give and I only hope that you will act promptly on the most recent proposal presented to break the log jam. This is a genuine crisis and only a positive intervention by you will save the system from total disaster. I urge you to reach immediate settlement of the ongoing differences.

In addition, may I respectfully request that you communicate with CSLFC, Bank of America, and the Letter of Credit banks and encourage them to go through with loan purchases they have in their possession so we can assist some of these unfortunate students.

Would you please inform me by fax (916-971-3156) or phone (916-971-8921) of your disposition of my request.

Very truly yours,

FIRST INDEPENDENT TRUST COMPANY

Deno Evangelista

Deno Evangelista
Chairman of the Board

DE:kj

UNITED STATES DEPARTMENT OF EDUCATION
THE SECRETARY

MAR 7 1989

Mr. Dano Evangelista
Chairman of the Board
First Independent Trust Company
1020 12th Street
P. O. Box 2310
Sacramento, California 95811

Dear Mr. Evangelista:

Thank you for your letter of February 9, 1989, concerning the efforts of the Department of Education to deal with the student loan servicing problems involving the California Student Loan Finance Corporation (CSLFC). I appreciate you taking the time to share with me your views on this subject.

As you know, Department of Education staff has been meeting and discussing this subject with all concerned parties (including Bank of America, which serves as trustee in this transaction) for several months. All parties, including Bank of America, have been given every opportunity to present new facts or arguments, to make their case for exceptional treatment by the Department, and to explain the consequences that some of the parties fear may flow from the policy stated in the January 30, 1989, letter signed by Deputy Under Secretary Kolb and Assistant Secretary Whitehead. In short, we have been, and remain, open to any reasonable argument or evidence that Bank of America or any other party wants to put before the Department of Education.

It was in this spirit that I personally met with Mr. A.W. Clausen, Chairman of Bank of America, on January 31, 1989. At that meeting I pledged to Mr. Clausen an early decision from me regarding this matter. Subsequently, I was advised by Messrs. Kolb and Whitehead that Bank of America officials requested additional time to make their case, as represented by Mr. Griffith, the Bank's Executive Vice President. Another round of discussions was scheduled as a result of that request. I believe that the Department has been fully responsive to the concerns of all parties with an interest in the CSLFC matter.

Finally, you may be assured that the Department of Education is giving top priority to the needs of students in making any final decision on this matter. Students, after all, are the reason for the Stafford Loan Program, and our overriding goal is to make sure that our administration of the program serves the needs of students first, last, and always. I know you share that view, and on reviewing the record I am sure you will find that all the Department's actions in this matter have been firmly guided by our common goal of preserving the integrity of the Stafford Loan Program in a way that increases student access to a quality education.

Sincerely,

Lauro F. Cavazos

Lauro F. Cavazos

EXHIBIT H

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202

Hearing Follow-up Questions

DEMO EVANGELISTA
President
First Independent Trust Company

Question: How often were you on site at FITCO? Do you think you had more than general knowledge of all operations at the trust company?

> Answer: I was on site at one of the two FITCO offices virtually daily. I had general knowledge of all aspects of the business operation of FITCO. I had more detailed and specific knowledge of the student loan program, trust rate accounts, and the interaction of FITCO with secondary lenders, state and federal regulatory agencies and public and private guarantee agencies. I also had more than a general working knowledge of the rules and regulations, both federal and state, related to the student loan program. I did not actively participate on a regular basis in other aspects of corporate and trust side activities as I had delegated the responsibilities in those areas to others.

Question: United Education and Software charged FITCO $33.00 for each loan it originated for FITCO. CSLFC paid FITCO one percent of the loan amount, which, for a typical $2,625 Stafford loan would be $26.25. How did FITCO make money under this scenario?

> Answer: The way this question is framed it would appear that on each transaction described, FITCO would have operated at the rate of minus $6.75 per transaction. Common sense suggests that FITCO would not have survived generating several million dollars in student loans and losing money on each individual student loan process at or near the rate suggested in the questions. From approximately 1984 in connection with its involvement in the student loan program, FITCO utilized the services of UES for loan processing services jointly with CSLFC as its principal. A fee schedule was created by CSLFC which reflected UES's participation and by use of a grid system it was determinable how old a given loan was when it entered the system and the dollar amount of each such loan. For example, if a student had a loan approved in his or her first year of college and the note was a four-year note, the extent of UES's administrative responsibilities was limited to logging the loan into its computer system for action four years and six months later when the first loan installment payment was due form the student. If the

> student dropped out of school, six months after the drop date when payments for the student would be due to commence, UES was charge with the responsibility to exercise due diligence to collect those loan payments. UES's due diligence requirement for CSLFC's loans included exercising reasonable efforts to collect on loans in default to satisfy federal regulations passed pursuant to the Education Act of 1965. This enabled CSLFC to seek reimbursement for loans in default that were uncollectable from the federal government and the state government through the California Student Aid Commission which acted as guarantor of the loans.
>
> The grid system referenced above reflected a fee high of $33.00 per transaction for UES's services depending upon the length and amount of the loan and how soon UES would be required to exercise or commence its due diligent loan collection procedures. Thus, the longer the loan term and the higher the loan amount, the larger the fee UES was to received up to a maximum of $33.00 per loan. It should be noted that $3.00 of that referenced fee maximum was designed to reimburse UES for the cost of running credit checks on given student borrowers. To my knowledge that was never done. Therefore, the maximum UES ever collected for a given loan service was $30.00. By referring to CSLFC records, it would be easy to ascertain in more detail how this system operated. I am providing this response to the best of my personal recollection without having the benefit of records to refresh my memory.

Question: At the time FITCO was taken over by California State Banking Department, how much money do you estimate FITCO owed the Department in origination fees? Where is that money now? Does the G.O.P. account still exist with this money, and if so, where is it?

> Answer: Since I have been denied access to the books, records, accounts, and computer programs maintained at FITCO's offices which together could answer this question, I can offer no specific response to this question.

Question: Was an individual trust rate customer able to see where his/her individual investment were made? Did you have knowledge of a phony computer program that was run when an investor inquired about his student loan investments?

> Answers: Any trustor could come to or telephone FITCO's offices and inquire as to the makeup of his or her trust account including which student loans were assigned to their account. It would have taken considerable time to determine that information for the trustor due to the high volume of loans being funded by the numerous trustor accounts; however, it would have been done. To my knowledge no such requests were ever made either in person or by telephone.

Question: Did FITCO have an account at Security Pacific Bank in which some refund money was maintained? Was this money "swept" out of the account to an interest-bearing account almost nightly?

> Answer: A corporate account existed at Security Pacific National Bank in FITCO's name. This account was one of many corporate accounts maintained in numerous other banking institutions and was an interest-bearing account as were the other corporate accounts to the best of my knowledge and belief.

Question: Should lenders be forced to share some of the financial risk in making guaranteed student loans?

> Answer: Absolutely not. A trust is entitled to all of the income less any trustee fees payable pursuant to the trust instrument. In the context of student loan purchases made with the assets of any individual trust, the risk of loss to that trust is limited to those investments made by that trust. Each individual trust account stands on its own.

Question: In your statement, you speak of the "animosity" of the California Banking Department against FITCO; the "adversarial" nature of the relationship between you and the California Banking Department and, finally, "the intensity of the Banking Department's effort to destroy FITCO." What prompted this supposed "vendetta" by the Banking Department against you -- why would FITCO by singled out for such treatment by a State regulator?

> Answer: It is my belief that FITCO was singled out because the operation from the beginning was considered to be "unconventional" and I was viewed as a "maverick" in financial circles. These circles included conventional banking institutions in the private sector and the State Banking Commission in the public sector>

I further believe that several commercial banks resented the success I was realising with the innovative and profit-production techniques I employed causing FITCO to become the second largest student loan originator in the country. This institutional jealousy was translated into a pattern of complaints over a long period of time made to the State Banking Commission which resulted in the continuance harassment of FITCO and myself by the agency.

The harassment which I addressed in my testimony and subsequent letter to you was premised upon a negative approach to my business taken by the staff at the Banking Commission from the time I first applied for my charter. I was told then that there was no need in Sacramento for the services I offered to provide and further that my business would not succeed even if they granted me a charter. I was forced to seek redress from the courts which ultimately required the Banking Department to grant my charter.

Question: Isn't it true that the Banking Department's actions were prompted by some valid concerns over FITCO's financial stability?

- In April, 1989, HEAF conducted a program review, making the following findings:

  1. Non-payment of origination fees. Even though FITCO withheld the origination fees from borrowers' proceeds, FITCO failed to pay these fees to the Department of Education after January 1, 1988. According to FITCO's internal records, over $4.6 million was owed for 1988.

  2. Non-payment of guarantee fees. As was the case with origination fees, FITCO withheld the guarantee fees from the borrowers' loan proceeds and was reimbursed for such fees when the loans were sold. Despite extensive efforts by HEAF to collect past-due fees to permit FITCO to reconcile accounts with its secondary markets -- and the granting of extensions of several deadlines -- FITCO failed to pay a significant portion of these past-due fees.

  3. Commingling of funds. The examination of FITCO's banking and accounting records indicated that FITCO was commingling funds it held in various capacities in a single account. Tuition refunds, proceeds from the sales of loans, and investment earnings were all deposited into a single

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account. The funds in this account were used to fund new loans, pay guarantee fees, and cash out trust participants.

Is it your opinion, under oath, that all of these findings by CSAC and HEAF were "false"?

Answer: While the Banking Department's concerns may have had some legitimacy to them, they did not to me. Continuous auditing was conducted virtually without relief by the Department of FITCO's operations from 1980 until closure in May of 1989. Each such contact from the Banking Department was accusatory and created an atmosphere of hostility and an undercurrent of suspicion that FITCO was some how operating illegally and was in the business of defrauding the public for profit. Since it was my business to conduct FITCO's affairs in a manner consistent with a continuing benefit to the trust account FITCO was charged to protect and enhance, the atmosphere created by the Banking Department staff made it virtually impossible for me to do so.

In fact, on each occasion when FITCO was "capital impaired", I, as an individual, contributed my own funds into the "paid-in-capital" account which contributions are reflected on FITCO's statements of condition. Over the years I made several such contributions which in total amounted to approximately $100,000. The actual amount can be verified by reference to FITCO's books to which I have been denied access. At the time FITCO was closed by the banking department I was prepared and capable of providing sufficient funds to correct the then existing capital impairment. The staff of the Banking Department was aware that I had made these contributions in the past. It should also be noted that in addition to the foregoing, I provided an overdraft protection fund account from my own funds for access by our bookkeepers to cover any overdrafts arising from trust rate account activities.

Question: You stressed to the staff that you -- through FITCO -- helped thousands of disadvantaged students. How did the failure to process refunds and loan cancellations help these students?

Answer: The HEAF program review of April 1989 was, in my view, a smokescreen to attempt to deflect attention from what it knew was coming regarding its own operations. These included its own bankruptcy and failure to properly service the loan accounts for which it was a guarantor. It should be emphasized that their review of FITCO occurred less than one month before the Banking Commission assumed control of FITCO. To suggest that these two entities were not acting in concert stretches credulity to its maximum.

The alleged non-payment of loan origination fees and loan guarantee fees was subject to the reconciliation process described below at the time FITCO was closed. The alleged commingling of funds suggesting that FITCO routed such diverse income sources as tuition refunds, proceeds from loan sales and corporate investment earnings into and out of a single account is not true. In fact, FITCO maintained thirty to forty accounts on the trust side of tis business and twenty to thirty accounts on its corporate side. All of the latter accounts were used to pay legitimate debts owed by the corporation. I personally have no knowledge of any commingling of funds as is suggested by this question, except by possible administrative inadvertence or error. When such errors were discovered, they were automatically corrected by my staff.

Question: Your statement claims that "the Banking Department, in its rush to close FITCO down, failed to understand that the reconciliation system put into effect by FITCO would have resolved the disputed payments." Please describe what this "reconciliation system" was. When was it put into effect? FITCO had been cited several times for failure to make all sorts of payments: 1986 (refunds); 1987 (origination fees and refunds); 1988 (origination fees); and 1989 (refunds, origination fees). Why wasn't this so-called "reconciliation system" put into effect years ago?

Answer: The way this question is phrased is to make it, in my opinion, a "loaded question" not dissimilar to the questioning approach taken by the Banking Department when they subjected me and my staff to their interminable grillings, always suggesting that we had to have done something wrong or illegal. You assume that we "failed" to process refunds and loan cancellations to the detriment of current and past student borrowers or potential student borrowers of the future. I am not certain how you make that quantum leap, but FITCO cannot be held responsible for actions taken or in some cases not taken by institutions and regulatory agencies, both public and private, which cumulatively contributed greatly to the creation of "arrearages" in the categories referenced by this question.

Question: You say that the California Banking Department "rushed into" closing down FITCO. The Subcommittee staff, in their September 25th testimony, reviewed the Banking Department's oversight of FITCO over the years. They testified that:

> According to records reviewed by the staff, from 1975-1988 the banking department conducted nearly annual reviews of FITCO with the exceptions of 1982, 1984, and 1987. Those reviews are submitted for the record. Of these eleven reviews that the staff has obtained, none present a promising picture. In fact, several of these reviews were quite damning. Despite that fact, the trust company was allowed, even without being fined, to continue to operate under California banking laws, as well as in federally insured loan programs.

> Answer: The reconciliation system maintained at FITCO was always in effect from the beginning of FITCO's involvement in the student loan program up to the date FITCO's doors were closed. Reconciliation between FITCO, HEAF and CSAC was no different from reconciliations made by other eligible lenders with those agencies. It should be noted that the need for FITCO to implement its reconciliation procedures was magnified when HEAF ceased guaranteeing student loans from eighteen other states in 1988. This was because FITCO has numerous loans in those states and HEAF, who was the guarantor of those loans, was disputing the number of loan cancellations and refund demands which FITCO discovered and contended had in fact taken place in those eighteen states. The cumulative effect of this was to substantially increase FITCO's reconciliation process. HEAF's recent history which has included bankruptcy, the firing of its president and chief executive officer and the resignations of its Board member speaks for itself.
>
> This same reconciliation problem was further complicated by the conduct of CSAC in that its computer system became overloaded as well as containing numerous programming errors. I made specific inquiries and requests of CSAC by letters dated April 25, 1989 and May 10, 1989 (see enclosed). CSAC never responded to these crucial inquiries to either me or any member of my staff.

Question: Given that history of adverse findings, how can you seriously accuse the Banking Department of "rushing into" closing FITCO down?

Answer: My statement that the Banking Department's seizure of FITCO was "rushed" was premised upon the fact that even though their representatives sought and held meetings with me and my staff over the course of several years in attempts to discover what procedures might be employed to correct their perceived appearances of financial instability at FITCO, we could never agree what differentiated commercial banking from trust banking which has always been the main source of conflict between FITCO and the Banking Department.

In spite of our disagreement, there was no just cause for the Banking Department to close FITCO mid-quarter since I already had created a history of personally correcting any capital impairment problems experienced at FITCO. Furthermore, the reconciliation process was functioning and the Banking Department staff knew it was functioning. If I had been given approximately two weeks additional time, the process would have worked to resolve any alleged non-payments of origination fees, insurance and refunds which the Banking Department indicates it found at the time of seizure.

Question: In 1983, the State Banking Department was critical of a $10,000 loan given to Jon Smock, FITCO's attorney, that was in default. Was this loan eventually repaid by Smock? If so, how?

Answer: In 1983, to my knowledge, a loan in the amount of $10,000 was made by FITCO to Mr. Jon Smock, a local attorney. At the time this loan was made, Mr. Smock was not officially associated with FITCO in any capacity. He became a Director and General Counsel to FITCO on or about April 1984. The loan was repaid by him in full at or around that time. How this loan was paid would be revealed by reference to FITCO's books to which I have no access. I have no personal knowledge as to the details of the loan's repayment.

Question: Were monies intended for student loans, trust rate funds, ever comingled with corporate funds at FITCO?

Answer: As I have stated previously, student loans and "trust rate" were one and the same. The short answer to the issue of commingling corporate and trust funds is that it was not done as a matter policy at FITCO. For a further detailed answer to this question, please refer to my response to Question 9 herein.

1 FIRST INDEPENDENT TRUST COMPANY
The INTRUST Bank
Chartered 1975

Deno Evangelista
President and Chairman

April 25, 1989

Dr. Sam Kipp
Director
California Student Aid Commission
1515 "S" Street
North Building, Suite 500
Sacramento, California 95245-0625

Dear Dr. Kipp:

First Independent Trust Company (FITC) needs the following information from the California Student Aid Commission as part of our efforts to meet the demands made by the Commission in its April 14, 1989, report of the compliance review of FITC:

> A detailed transaction by transaction accounting of the dollars paid by FITC to the Commission for insurance premiums and how they were applied to individual GSL, SLS and PLUS loans. The accounting must relate individual payments to transactions processed. Also needed is a detailed accounting of all funds (by source) not applied to specific loans. This information is necessary for the period discussed in the report, that is, 1985 to present.

In light of the deadlines imposed on FITC by the Commission to respond to the compliance review, FITC must request this information be provided by May 1, 1989. Failure to provide the requested information will significantly impede our efforts to meet the Commission imposed deadlines.

Thank you for your immediate attention to this matter.

Sincerely,

FIRST INDEPENDENT TRUST COMPANY

Deno Evangelista

Deno Evangelista
Chairman of the Board

DE:kj

MAIN OFFICE: 1020 12th Street, Post Office Box 2310 • Sacramento, CA 95814 • (916) 971-8900
STUDENT LOAN CENTER: 5325 Engle Road, Carmichael, Post Office Box 2562 • Sacramento, CA 95812 • (916) 971-8920

1 FIRST INDEPENDENT TRUST COMPANY
The INTRUST Bank
Chartered 1975

Deno Evangelista
President and Chairman

April 25, 1989

Dr. Sam Kipp
Director
California Student Aid Commission
1515 "S" Street
North Building, Suite 500
Sacramento, California 95245-0625

Dear Dr. Kipp:

First Independent Trust Company (FITC) needs the following information and action from the California Student Aid Commission as part of our efforts to meet the demands made by the Commission in its April 14, 1989 report of the compliance review of FITC:

The Commission's report alleges that FITC is not reporting disbursements properly to the Commission. However, a review of the rejections generated by the CSAC system reveals a majority of the recent SLS/PLUS rejections are improper rejections. That this is the insurance premium fee we are reporting and attempting to pay the Commission is correct, yet the Commission has rejected several thousand of these transactions. We have verified that the fee amount is correct using information directly from the Commission. We have also notified CSAC of this problem, provided examples of the erroneous rejects and have received no response. FITC has lost hundreds of man-hours of work preparing the transactions for submission and working the erroneous rejects.

In light of the apparent erroneous information included in the Compliance Review Report and the deadlines imposed on FITC by the Commission to respond, FITC must request that the Commission:

1. Rectify immediately the error(s) in the CSAC system.
2. Provide a full explanation to FITC of the cause of the error(s) and how long it (they) existed. This is needed so that FITC can begin to make arrangements to correct the effects of the improper rejects on our system.
3. Provide a comprehensive and detailed electronic and paper report that lists all the transactions erroneously rejected by the Commission.

4. Reapply all the erroneously rejected transactions to the system. Provide an electronic and paper report of the transactions accepted and rejected.

The requested information and action is essential to FITC's ability to respond to the allegations raised in the report and the deadlines CSAC has imposed. Therefore, we request that the information and action be completed by May 1, 1989.

Thank you for your immediate attention to this matter.

Sincerely,

FIRST INDEPENDENT TRUST COMPANY

Deno Evangelista

Deno Evangelista
Chairman of the Board

FIRST INDEPENDENT
TRUST COMPANY

5325 Eagle Road
Carmichael, CA 95608
P.O. Box 2362
Sacramento, CA 95812
(916) 971-8921

May 10, 1989

HAND DELIVERED

Mr. Samuel M. Kipp III
Executive Director
California Student Aid Commission
Post Office Box 945625
Sacramento, California 94245-0624

Dear Mr. Kipp:

On April 25, 1989, I made a special request. I received your reply dated May 1, 1989. However, your reply is not what I asked for. Let me try again.

We know that a lender can reconcile premium fees, but because these amounts are carried over from one manifest to another it is impossible for us to determine to what individual accounts they were applied by you. Please provide us with this information for the amounts listed below for lender ID #828374 and ID #828411:

828374:

The amount transferred to Special Account on 01/07/88 ..$226,020.50.
The amount transferred to Special Account on 02/04/88 ..$163,816.35.
The amount transferred to Special Account on 02/04/88 ..$43,937.33.

828411:

The amount transferred to Special Account on 01/07/88 ..$70,214.75.
The amount transferred to Special Account on 02/04/88 ..$96,995.20.

If you cannot provide the information requested, please so state and give us the reasons why you cannot provide it.

Sincerely,

Deno Evangelista

DENO EVANGELISTA
President and Chairman

DE/dc

Statement

of

Aaron Cohen

Before the

United States Senate
Committee on Governmental Affairs
Subcommittee on Investigations

September 26, 1990

I appreciate this opportunity to appear before the Subcommittee on Investigations. To the extent that the subcommittee's work will result in recommendations for improvements in the Guaranteed Student Loan program designed to reduce fraud and abuse, the taxpayers will be well served. To the extent that the subcommittee's recommendations improve access and opportunity to quality education and training, all students, and particularly disadvantaged students will be well served.

As the former President and Chief Executive Officer of United Education & Software, Inc., I have witnessed first hand the evolution of the GSL program over nearly two decades. As one who headed a publicly owned corporation during a five-year period when one of the corporation's subsidiaries provided loan servicing and loan application services to some of the nation's largest lenders, I have learned by painful example how major aspects of the GSL program are seriously flawed.

In the brief time allotted, I hope to share with the subcommittee three things:

1. A brief outline of what loan servicers do and how they fit into the complex map of the GSL programs;

2. A synopsis of what went wrong two years ago with the UES loan servicing operation; and

3. Some ideas and recommendations on how the GSL program can be structurally improved to facilitate better servicing of student loans.

Based on its substantial experience with data processing systems and the servicing of our own NDSL loans, in 1983 UES made a business decision to enter the GSL loan servicing arena. At the time, the Federal government was strongly encouraging participation in the GSL program by more lenders, secondary markets, and guarantors, in order to assure more access for borrowers. Loan servicers played an important role in this expanded access, because they relieved lenders and secondary markets of the operational tedium of borrower contact and billings.

Essentially, a loan servicer does nothing more than send out bills, collect and post loan payments, and contact delinquent borrowers as specified by Federal regulations. Servicers perform ministerial functions. Servicers do not make loans, approve loans, or act as collection agencies for defaulted loans.

As a loan servicer, UES was compensated by lenders and secondary markets on a per-loan basis. We did not receive any Federal payments or subsidies, and we did not share in any profits made by lenders. Indeed, it is particularly worth noting that it is not in a servicer's best economic interests for a delinquent loan to go into default, since the submission of a default claim by the lender or secondary market results in the loan being removed from the servicer's portfolio, thus terminating the fee base for that loan and reducing revenues for the servicer.

Individual banks and secondary markets such as the California Student Loan Finance Corporation (CSLFC) contracted with our loan servicing division, and from 1983 through 1987, our servicing portfolio grew from zero to $600 million. Reflective of the rapid volume growth in the GSL program, the service center portfolio jumped from $600 million to over $1 billion from 1987 through 1988.

In reality, UES had virtually no control over this rapid increase in volume. The increase reflected the rapid growth in loans made by lenders that were doing business with our servicing center. The increases also reflected the fact that Guaranteed Student Loans were overtaking student grants in the 1980s as the principal mechanism by which students were obliged to fund their postsecondary education.

As volume increased, our existing computer systems proved inadequate to accommodate this rapid growth. In October 1987 the service center responded to this problem by installing a new software package on new IBM hardware. The software was intended both to greatly expand loan servicing capacity and to incorporate changes mandated by complex new regulations promulgated by the Department of Education.

These regulations went into considerable detail in specifying a "due diligence" process that had to be performed on every loan that went delinquent before such a loan could be considered in default and presented to a guarantor for payment. Among other things, this process included specific sequences of phone calls and specific types of letters to student borrowers. The regulations provided no tolerance for error; sending a letter one day late was sufficient grounds to disqualify a loan for claims payment.

After our new computer system was installed, both UES and its principal customer, CSLFC, detected problems with regard to month-end accounting closings. In February 1988 UES and CSLFC engaged the accounting firm of Peat, Marwick, Main and Co. -- now KPMG Peat Marwick -- to review the loan servicing systems. As a result of that review and its findings, in March 1988 UES engaged Peat Marwick to modify or rewrite its software systems to correct the known accounting problems.

However, due diligence and regulatory compliance issues surfaced after an on-site review conducted in June 1988 by the Higher Education Assistance Foundation, a national guarantor, and by the summer and early fall of 1988, it became evident that the processing systems at our loan servicing center were not able to fully comply with the new Federal due diligence regulations. The nature of the difficulties was further defined when, in August, 1988, an audit report issued by the U.S. Department of Education called into question the validity of guarantees for approximately half the loans in the service center's $1 billion-portfolio on the basis that due diligence was not adequately documented.

By that time, UES was aggressively engaged in resolving the difficulties in the loan servicing operation. Senior management of the loan servicing division was reorganized and a number of banking and data systems professionals were brought in to take the necessary corrective action. As a result of these steps, in late August, 1988, UES submitted to the Department of Education a complete corrective action plan designed to solve the due diligence problems without any additional costs to taxpayers. However, the Department did not respond to this proposal, and subsequently, in November, 1988, UES sold the assets of the servicing center to the Bank of America at a considerable loss and entirely disengaged from the loan servicing business.

Two years have passed since this painful and highly publicized episode. During this time period, United Education & Software has paid a very high price for the problems its servicing center faced in meeting the due diligence requirements. The company registered almost $9 million in losses attributable to the loan servicing center alone, and the value of the company's stock has dropped from a high of more than $16 per share to a current value of approximately six center per share. Annual revenues have fallen nearly half from their high two years ago, and last December the company's principal operating subsidiary was forced by its financial circumstances to file for Chapter 11 protection with the U.S. Bankruptcy Court.

I have engaged in considerable reflection on these events. As a professional quality control engineer, I am personally embarrassed. In looking back at what happened, I believe that the problems we experienced with our loan service center had two principal causes. First, the loan servicing segment of our business grew too rapidly, in concert with the rapid growth of the program as a whole and the rapid growth of certain lenders' portfolios. This growth was beyond the capacity of the service center and the company's existing computer systems to adequately manage.

Second, the new Federal due diligence requirements were extremely complex and were issued with little lead time to allow lenders, secondary markets, and servicers to adapt and adequately test their systems. The new regulations, which left zero tolerance for errors, whether minor or major, were oriented toward specifying a process of servicing student loans rather than seeking to ensure achievement of the goal of minimizing defaults through a diligent servicing process.

If we had it to do all over again, I believe we should have tried to control the exponential growth in servicing business that attended the rapid growth of the GSL program. With 20-20 hindsight, we should have set specific annual limits on the growth of our loan servicing portfolio to allow sufficient opportunity for better staff development and data systems enhancement, as well to accommodate changes in the regulatory structure, even if that might have meant losing some business.

Having said all this, I also believe that the problems experienced by UES were not unique. The fact of the matter is that the architecture of many student loan servicing systems derives from computer programs originally designed in the private sector for other purposes such as home mortgage and automobile loans. Such loans are collateralized, so if a delinquent borrower fails to pay back a loan, the house or car can be repossessed. But as others have noted, with student loans it's impossible to repossess someone's education.

Student loans, therefore, are unique, and the due diligence practices for student loans are also unique, and most assuredly, such practices have not been adequately researched or refined. I believe that student loan servicing can best be improved by restructuring and refocusing the current Federal regulations to concentrate more on outcomes rather than process. More phone calls and more warning letters to delinquent borrowers may look good on paper, but in the real world do they really save the taxpayers money by preventing defaults?

This question and others should be independently researched, with the involvement of expert practitioners in the credit management field. But as one who has been involved in this area, let me offer a few suggestions.

I believe the current rules should be revised to allow servicers who have made contact with delinquent borrowers to suspend the required sequence of phone calls and letters if there is reason to believe that this will enhance a borrower's willingness to make a payment. We can all attest from experience with computerized credit card billing systems that there is nothing worse then getting a harassing letter a few days after we've sent in a payment check. Unfortunately, current Federal rules do not permit servicers to exercise any professional judgment in such cases.

I also believe that lenders, servicers, and secondary markets should be required to apply loan refund amounts received from postsecondary institutions to borrowers' accounts within a fixed time period, perhaps 30 days from receipt. Believe it or not, current law requires that colleges and trade schools send refund checks to lenders within a specified timeframe, but there's no parallel requirement that the lenders track down who currently owns or services the loan and remit the refund within any timeframe whatsoever. This loophole in the paper chain may very well result in the Federal government paying higher default claims than the actual loan balances.

Finally, I believe that the GSL program could be with increased oversight of loan servicers. Perhaps the Department of Education should be authorized to review and approve loan servicers, in the same fashion that the Department reviews the administrative capability and performance of loan guarantors. After all, loan servicing is, in essence, a subcontracting of a key guaranteed student loan function, and the government has every legitimate right to place it under the same sort of umbrella of controls that governs other forms of procurement. Lenders and secondary markets would not be permitted to contract with a servicer lacking such approval. Servicers might also be limited to a specified volume, based on their performance record and on their in-place capacity.

In closing, let me echo the sentiments expressed by others who have appeared before this subcommittee. The American economy of the 21st century will fail to remain competitive with other nations if we do not continue to do everything we can to provide proper access to postsecondary education for all its citizens. The GSL program serves an essential purpose in providing a broad range of educational opportunity to millions of deserving Americans. In the effort to minimize its cost to the government we must not lose sight of its importance in assuring the continuation of that access.

Thank you.

Responses of Aaron Cohen to Subcommittee Follow-Up Questions

Question: Prior to the creation of CSLFC and UES' agreement with that agency, what was your relationship with Mr. Jay Olins, former CSLFC president?

Response: Prior to the creation of CSLFC, Mr. Olins was executive director of the Western Association of Career Colleges and Schools (WACCS). UES was a long-time member of the Association and Mr. Cohen knew him in this professional capacity.

Question: The Subcommittee has received allegations that you were involved in dumping your UES stock shortly before this fiasco received public attention. Can you comment on these allegations?

Response: Mr. Cohen categorically denies these allegations. At the beginning of 1988, Mr. Cohen owned 419,767 shares of UES common stock. During 1988, Mr. Cohen sold 20,000 shares solely to payoff his margin account, which occurred in February or March of that year. He did not sell any other shares until January, 1989, when he sold 37,000 shares to cover margin calls. In August, 1988, Mr. Cohen donated 1,400 shares to a university, in December, 1988, he donated 2,500 shares to a major California university and 5,000 shares to his synagogue, and in August, 1989 he donated 10,0000 shares to the same California institution, 4,000 shares to another university and 6,000 shares to two synagogues. In 1988 and 1989, Mr. Cohen transferred 40,000 shares by gift. At the time of the bankruptcy proceeding, Mr. Cohen owned 313,867 shares. Subsequent to the Chapter proceeding, Mr. Cohen purchased 40,000 shares and at the present time he owns 353,867 shares of UES common stock.

Question: Do you recall being informed by Gretchen Staff that employees were over loaded with work? If so, did you provide her with the type of assistance she requested? If not, why not?

Response: Mr. Cohen recalls that from time to time, Ms. Staff informed him that the rapidly growing volume of work was necessitating increases in staffing levels. She was authorized by Mr. Cohen to, and did in fact, significantly increase staffing to meet demand. Substantial numbers of temporary personnel were also employed to supplement regular staff to accommodate surges in volume that arose due to the inability of CSLFC to accurately predict volume. On three occasions, from 1968 to 1988, UES moved its processing operations to larger facilities. Each move involved substantial capital expenditures for equipment and leasehold improvements, increasing the size of the processing facility from an original space of approximately 1,000 square feet to approximately 40,000 square feet. These moves were intended to both alleviate workload problems and to increase productivity.

Question: The Subcommittee has received allegations that some of the audits of UES were performed by individuals who were relatives or were personal friends of yours. Were any audits of UES ever performed by any individual who was in any way related to you, or a personal friend of yours? If so, which audits and when did they take place?

Response: To the best of Mr. Cohen's recollection, no audit of UES was performed by any individual who was a relative, or a personal friend, of Mr. Cohen.

Question: Did you ever have any indication from any of these reports that UES was experiencing problems with its loan-servicing operations?

Response: Mr. Cohen assumes that this question refers to any audit reports on the loan-servicing operation. Mr. Cohen recalls that he received a letter summarizing the findings of the HEAF audit in mid-July, 1988. That was the first report that indicated any serious problems might exist. Indications of some problems were referred to in a March, 1988 USAF letter to Ms. Staff. However, the audit exit interview conducted by USAF in early June, 1988 discounted the significance of the issues raised in the earlier letter.

Question: Knowing that Ms. Staff had no prior experience in the student loan area, did you take any steps to keep yourself more personally involved in UES's servicing operations? How often did you personally visit the UES service center?

Response: The inference that Ms. Staff was hired to the position of manager of the loan servicing operation is incorrect. Ms. Staff was hired by UES as a program analyst, for which she was thoroughly experienced and indeed had been previously employed in a similar capacity by the firm that had developed the software that was then in use by UES. After UES received its first contract to service student loans, Ms. Staff was responsible for the development of the software to perform this function, and was the first employee of the student loan servicing group, reporting to a Vice President of UES. By 1988, Ms. Staff had six years of management experience in student loan processing. After the servicing operation grew substantially, Ms. Staff began to report directly to Mr. Cohen.

As Chief Executive Officer, Mr. Cohen did not become directly involved in the day-to-day management of the Company's operating divisions. He recalls visiting the servicing center roughly once a month, and meeting with UES senior management, including Ms. Staff and other operations managers, on a more frequent basis. Mr. Cohen spoke frequently with Ms. Staff by telephone and was directly involved with her in the development of the strategic plan for the servicing center. Mr. Cohen notes that at least once each year he had a formal meeting with all employees of the servicing center, as he did with all UES units.

Question: Ms. Staff has stated previously that your usual response to her reports was "Let's keep CSLFC happy." Why was keeping CSLFC happy so important?

Response: Mr. Cohen recalls that every report by Ms. Staff was very seriously considered, discussed with her and appropriate action decided upon. Obviously, CSLFC was a major client of the Company, and Mr. Cohen's policy, which he articulated to all management staff, was to insure that the Company was at all times responsive to the needs and priorities of its customers.

Question: Did you ever make any attempt to determine who at UES had created the FIX and COMFIX programs, and the reason why these programs had been created and used? If so, what did you determine?

Response: Mr. Cohen had no knowledge of the existence of these programs until after the servicing center was sold to Bank of America. Subsequent to the sale of the servicing center, UES staff did examine the programs but could not reach any conclusions respecting why they were created or used, or the actual identity of the responsible persons. Mr. Cohen recalls that in July, 1988, there was a Company inquiry to determine the origin and basis of what appeared to be unusual telephone information in the data base. He recollects being informed that, although the actual computer program could not be located, the conclusion was that the information was part of a system test. A subsequent review of "COMFIX" and "DATAFIX" programs by Company employees was inconclusive.

Question: You stated that based on the August, 1988, audit report, the Department of Education questioned the guarantee on half the loans in the UES portfolio, because "due diligence was not adequately documented." In fact, didn't the audit report disclose far more than merely a failure to adequately document? Don't you think [the enumerated issues] were very serious shortcomings in your operations?

Response: Each of the issues raised in your inquiry has been fully addressed in the Company's response to the August, 1988 Audit Report, which we understand is in the possession of the Subcommittee.

Question: Your statement also claims that, responding to those claims, you offered a "complete corrective action plan designed to solve the due diligence problem without any additional costs to taxpayers." You state that the Department failed to respond to this plan and, therefore, UES sold its assets to Bank of America.

a. **What was the corrective action plan you offered?**

Response: The plan, which was sent to the Department of Education, would have utilized corrected software to recycle all student accounts beginning in February, 1989, as though that was the first billing, thus enabling the servicing operation to bring all student accounts back into appropriate status. The full plan, entitled Regulatory and Compliance Due Diligence Project, was prepared by Peat, Marwick and submitted directly to the Department. Mr. Cohen does not presently have a copy of that document. However, a copy of a progress report on the Status Change Plan, as prepared by UES and provided Deputy Assistant Secretary Newman, is attached, together with its transmittal letter that also reflects the Peat, Marwick submission. Also enclosed is a copy of the management overview of UES' "technical recovery program," the details of which are in the Peat, Marwick materials.

b. **How was the plan going to be funded?**

Response: Mr. Cohen recalls that the Company offered to pay the entire cost of the new software, while CSLFC would pay the Interest Benefit and Special Allowance differentials, for which CSLFC had already established a reserve.

c. **If this plan was as good as you say it was, can you explain the testimony by Richard Fulp?**

Response: Mr. Cohen cannot explain either Mr. Fulp's testimony or The Bank of America's unwillingness to work with UES to resolve the problem.

Question: From 1986 to 1988, UES experienced an increase in the number of claims rejected by guarantee agencies, did it not? Could you describe for the Subcommittee the progression of this increase? Did this increase in rejected claims ever raise any concerns in your mind or in anyone else's mind about potential problems with UES's due diligence requirements?

Response: Mr. Cohen has no recollection of any unusual increase, except in relation to the overall increase in portfolio volume, which increased from $400-million in 1986 to $1.1 billion in 1988. He does recall that in July, 1987 there was a problem concerning the electronic transmission of information between the servicing center and CSAC involving approximately 15,000 files, which CSAC subsequently claimed were not received. This was not, however, a reject of claims issue. Mr. Cohen recalls that the Company's computer and telephone transmission records verified the transmission of the data. The March, 1988 USAF letter referred to above indicated that there were a relatively small number of loan rejections.

Mr. Cohen notes that changes in the law arising out of the 1986 amendments to the Higher Education Act significantly increased the complexity of student loan processing. These changes necessitated a massive rewrite of the software. However, as Mr. Cohen has previously stated, the revised software did not function properly, causing unforeseen processing problems, the magnitude of which did not become evident until July, 1988.

December 4, 1990

UES

United
Education &
Software

Executive Offices
15720 Ventura Boulevard, Suite 312
Encino, California 91436
(818) 907-6649

August 25, 1988

Dr. Dewey Newman
U. S. Department of Education
400 Maryland Avenue S.W.
Washington, D.C. 20202

Dear Dr. Newman:

Attached is the current progress report on the "Status Change Project" prepared by Peat Marwick Main & Company (PMM).

Jeremy Gross of PMM will forward to you directly, the progress report on the "Regulatory and Compliance Due Diligence Project" within 48 hours.

Sincerely,

Aaron Cohen, President

cc:
Lee Benedict (UES)
Jerry Gross (PMM)
Dick Hawk (HEAF)
Jack Keefe (USDE - San Francisco)
Sam Kipp III (CSAC)
Dan Lau (USDE - Washington, D.C.)
Roy Nicholsen (USAF)
Jay Olins (CSLFC)
Jess Rifkind (Consultant - UES)
Michael Roe III (Bank of America)
UES Board of Directors

enclosures:

/bjk

MEMORANDUM

Date: 08/22/88
Memo: UES16

From: Jeremy V. Gross
Peat Marwick Main & Co.
Re: Status Code Change Project - Status reporting

Please find enclosed the following materials for your review:

- Narrative project status
- Project Background and Scope document
- Status Code Change Project gantt chart and detailed work steps
- Change Status correction process overview

I will continue to report the progress of this project to you on a weekly basis. If you have any questions related to the material enclosed please call me on (714)979-4300.

CC: Management Advisory Committee
Project Steering Committee
Project Files

UES/CSLFC DEVELOPMENT PROJECTS
Project Status Reporting
August 22nd, 1988

Project: Status Code Change

Date: August 22, 1988

Status: On Schedule

Impact: None

Accomplishments:
- Completed project plan
- Assigned project team resources to the project
- Developed project kickoff with walkthrough materials
- Conducted project kickoff meeting

Tasks Currently in Process:
- Define affected data elements
- Define business requirements
- Define compliance requirements
- Define/Identify all affected fields
- List program functions and conditions

Tasks Planned but not completed:
- None

Problems/Findings:
- None

Next Steps:
- Obtain user signoff to business and compliance requirements
- Develop program specifications
- Determine test data requirements
- Start programming
- Start manual procedures development

STATUS CODE CHANGE PROJECT
Project Background and Scope

PROJECT BACKGROUND

o Controls review
- Identified controls issues
- Copmpleted February 1988

o Month-End System Test Project
- Joint project between UES/CSLFC performed by PMM
- Completed March 1988

o Phased Projects
- Managed by MAC and the Project Steering Committee
- Phase I Stabilization
- Phase II System Re-Write
- Phase III Infrastructure
- Phase IV Other Systems Development

o Phase I Projects
- Security projects
- Data base cleanup
- System test environment
- Model 600 to 700 conversion
- Program change control

o Guarantor and DOE Audits
- Started in June
- Potentially serious violations in due diligence
- Second audit to confirm initial findings
- Startup of Due diligence and Compliance project
- All Phase I projects put on hold to address problems

o Current Plan
- Understand environment change (Banks,CSLFC,PMM,DOE,etc)
- DOE restrictions on UES/CSLFC (September IB/SAP, Unknown)
- Correct violations and return to full servicing
- Display our committment (Project resources and timeframe)
- Resume the Data base cleanup project

o Corporate Commitment
- Key to ongoing servicing of portfolio
- Vital in allowing Interest Benefit and Special Allowance Payments to continue (September)
- Critical in displaying our ability and purpose to correct the existing problems to the DOE et al
- All projects on hold
- SDRS/Phase projects/special requests/swaps
- Month-end/housekeeping
- Environment of solitude

STATUS CODE CHANGE PROJECT
Project Background and Scope

PROJECT SCOPE

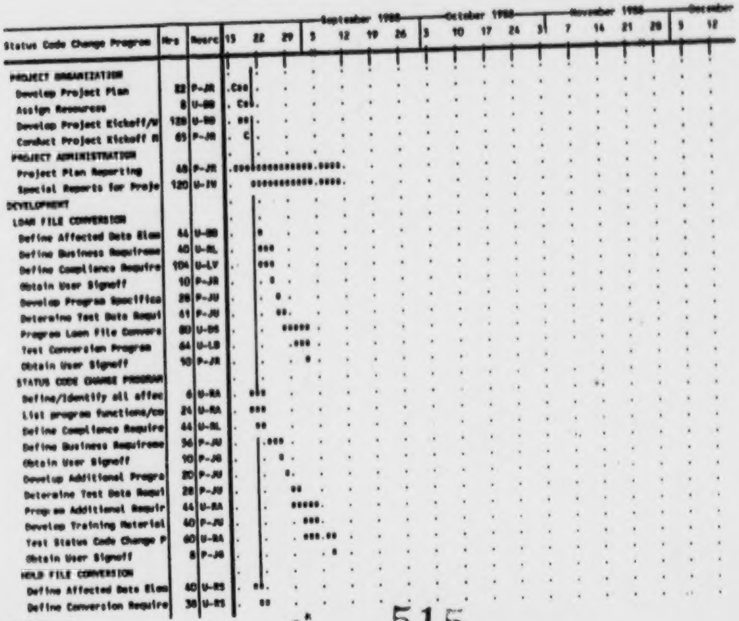
- o Perform Loan File Conversion
  - Correct file data to allow processing
- o Process backlog of deferments and status changes
  - Automated versus Manual correction
  - Process majority of backlog by project completion
  - Actively work unknowns
- o Process status code changes correctly and accurately
  - Prioritize status types
  - Automated versus Manual

PROJECT OBJECTIVES

- o Portfolio will reflect the true status
- o Limit the errors continuing to be processed due status code changes
- o Return to accurate due diligence as it relates to the status code change function

AUG 19 88 GANTT CHART PAGE 1

Status Code Change Program



Status Code Change Program	Hrs	Resrc
PROJECT ORGANIZATION		
Develop Project Plan	32	P-JR
Assign Resources	8	U-BB
Develop Project Kickoff/W	128	U-BB
Conduct Project Kickoff M	65	P-JR
PROJECT ADMINISTRATION		
Project Plan Reporting	48	P-JR
Special Reports for Proje	120	U-IV
DEVELOPMENT		
LOAN FILE CONVERSION		
Define Affected Data Elem	44	U-BB
Define Business Requireme	40	U-RL
Define Compliance Require	104	U-LV
Obtain User Signoff	10	P-JR
Develop Program Specifica	28	P-JU
Determine Test Data Requi	41	P-JU
Program Loan File Convers	80	U-DS
Test Conversion Program	64	U-LB
Obtain User Signoff	10	P-JR
STATUS CODE CHANGE PROGRAM		
Define/Identify all affec	6	U-RA
List program functions/co	24	U-RA
Define Compliance Require	44	U-RL
Define Business Requireme	36	P-JU
Obtain User Signoff	10	P-JG
Develop Additional Progra	20	P-JU
Determine Test Data Requi	28	P-JU
Program Additional Requir	44	U-RA
Develop Training Material	40	P-JU
Test Status Code Change P	60	U-RA
Obtain User Signoff	8	P-JG
HOLD FILE CONVERSION		
Define Affected Data Elem	40	U-RS
Define Conversion Require	38	U-RS

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| AUG 19 88                        GANTT  CHART                        PAGE  2 |
|                                                                              |
|                           Status Code Change Program                         |
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                                     ---------September 1988----------October 1988---------------November 1988---------December
Status Code Change Program|Hrs|Resrc|15  22  29 |5   12  19  26 |3   10  17  24  31|7   14  21  28 |5   12
--------------------------------------------------------------------------------------------------------------------------
  Obtain User Signoff     | 10|P-JR |.  |.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Develop Program Specifica| 24|P-MB |.  |X   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Determine Test Data Requi| 24|P-MS |.  |.XX .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Program Hold File Convers| 60|U-RM |.  |. XXXXX .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Test Conversion Program | 60|P-MS |.  |.  XXXXX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Obtain User Signoff     |  8|P-JR |.  |.   .  X.   .   .   .   .   .   .   .   .   .   .   .   .   .   .
HOLD FILE BACKLOG UPDATE P|   |     |.  |.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Define Functional Require| 30|P-PJ |.  |CXXX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Define Compliance Require| 20|P-PJ |.  |XXX .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Obtain User Signoff     | 10|P-JB |.  |. C .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Develop Program Specifica| 20|P-PJ |.  |.  C.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Determine Test Data Requi| 20|P-PJ |.  |.  XX   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Program Backlog Processin| 80|U-RM |.  |.  CXXXX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Develop Manual Processing| 28|P-PJ |.  |.   .  X.XXXX.  .   .   .   .   .   .   .   .   .   .   .   .   .
  Test Backlog Update Progr| 40|P-PJ |.  |.   .CXXX.X .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Obtain User Signoff     | 10|P-JB |.  |.   .   .C  .   .   .   .   .   .   .   .   .   .   .   .   .   .
FINANCIAL PROGRAMS CASH UP|   |     |.  |.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Define Functional Require| 52|P-RC |.  |XXXX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Define Compliance Require| 24|P-PJ |.  |XXX .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Obtain User Signoff     | 10|P-JR |.  |. X .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Develop Program Specifica| 28|P-RC |.  |.  X.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Determine Test Data Requi| 30|P-RC |.  |. XX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Program Financial Applica| 36|U-DS |.  |.  XXXXX.   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Test Financial Programs | 36|P-RC |.  |.   .XXXX.X .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Obtain User Signoff     | 10|P-JR |.  |.   .   .X  .   .   .   .   .   .   .   .   .   .   .   .   .   .
IMPLEMENTATION            |   |     |.  |.   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Run Conversion Programs |  4|P-JR |.  |.   .   . X .   .   .   .   .   .   .   .   .   .   .   .   .   .
  Implement New Programs  |  4|P-JR |.  |.   .   . X .   .   .   .   .   .   .   .   .   .   .   .   .   .
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AUG 19 88　　GANTT CHART　　PAGE 3

Status Code Change Program

						September 1988				October 1988					November 1988				December	
Status Code Change Program	Hrs	Resrc	15	22	29	5	12	19	26	3	10	17	24	31	7	14	21	28	5	12
Resource summary																				
Utilization																				
PMR/JOHN ROSENFELD	40	P-JR	19	15	9	13														
PMR/JERRY GROSS	40	P-JG	9	15	9	9														
UES/RICH LORITSCH	40	U-RL	18	37	38	8														
UES/BOB SEVERS	40	U-BS	28	38	22	12														
PMR/JULIE REEVES	40	P-JR	4	79	64	6														
UES/PROGRAMMER-ANALYST	140	U-PA																		
UES/RACHELE ADLER	40	U-RA	19	23	42	2														
UES/LARRY VAN VILLIGAN	40	U-LV	8	63	17	10														
PMR/RICHARD CRONE	40	P-RC	30	49	30	7														
UES/LISTA ELLIOT	40	U-LE	35	48																
UES/DEBRA SMITH	40	U-DS	22	37	37															
UES/GREG THIELEN	40	U-GT	22	37	37															
UES/SAL DEMELLO	40	U-SD	22	8																
UES/ROBBI SEBORIS	40	U-RS	18	31	36	8														
PMR/PAUL JOHNSON	40	P-PJ	2	69	25	10														
UES/LORI BOCKOUT	40	U-LB	1	19	20	4														
UES/REX MILLER	40	U-RM	16	34	26															
UES/JULIE PFAUTZ	40	U-JP		38	14	4														
PMR/MIKE SURFACE	40	P-MS	46	39	29															
UES/IRENE WARD	40	U-IW	8	40	40	32														
CSLFC/TRENT WEBEKER	40	C-TW		8																
UES/KATIE	40	U-K		24																
UES/JEFF MILNER	40	U-JM	18	35	17	6														
UES/MICHELE HIVELY	40	U-MH		12	30	4														
UES/DAVID GONZALES	40	U-DG		14	21	9														
UES/QUALITY ASSURANCE	40	U-QA		6	24	2														
Total hours			343	829	378	146														

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| AUG 19 88              ACTIVITY  DETAIL                  PAGE    1 |
|                                                                    |
|                   Status Code Change Program                       |
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                            Original dates and Usage

-----------------Name------------------  Start    End   Duration Status --------Resource assignments-------- Float Pty Category
                                                       Bus days        Name                 Usage     Cost


PROJECT ORGANIZATION

  040 Develop Project Plan            8-16-88  8-18-88    3          PMR/JOHN ROSENFELD      8.0               0
                                                                      PMR/JERRY GROSS         2.0
                                                                      UES/RICH LORITSCH       2.0
                                                                      UES/BOB BEVERS          2.0
                                                                      PMR/JULIE REEVES        4.0
                                                                      PMR/RICHARD CROWE       4.0

  080 Assign Resources                8-17-88  8-19-88    3          UES/BOB BEVERS          2.0               0
                                                                      UES/RICH LORITSCH       2.0
                                                                      PMR/JOHN ROSENFELD      4.0

  Develop Project Kickoff/Walkthru    8-17-88  8-18-88    2          UES/BOB BEVERS         16.0
  Materials                                                           UES/LIETA ELLIOT       16.0
                                                                      UES/DEBRA SMITH        16.0
                                                                      UES/GREG THIELEN       16.0
                                                                      UES/SAL BONELLO        16.0
                                                                      UES/REX MILLER         16.0
                                                                      PMR/MIKE SURFACE       16.0
                                                                      PMR/RICHARD CROWE      16.0

  120 Conduct Project Kickoff Meeting 8-18-88  8-18-88    1          PMR/JOHN ROSENFELD      3.0               0
                                                                      PMR/JERRY GROSS         3.0
                                                                      UES/RICH LORITSCH       6.0
                                                                      UES/BOB BEVERS          5.0
                                                                      UES/DEBRA SMITH         6.0
                                                                      UES/GREG THIELEN        6.0
                                                                      UES/SAL BONELLO         6.0
                                                                      PMR/RICHARD CROWE       6.0
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| AUG 19 88                ACTIVITY  DETAIL                       PAGE   2 |
|                                                                            |
|                        Status Code Change Program                         |
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                           Original dates and Usage

---------------Name---------------  Start    End    Duration  Status  -------Resource assignments-------  Float Pty Category
                                                     Bus days          Name                  Usage   Cost

                                                                       UES/LISTA ELLIOT        6.0
                                                                       UES/[illegible]         6.0
                                                                       PMR/MIKE SURFACE        6.0
                                                                       UES/JEFF MILNER         6.0

 PROJECT ADMINISTRATION

  Project Plan Reporting           8-16-88  9-09-88     18             PMR/JOHN [illegible]   16.0
    --Project Time Reporting                                           PMR/JERRY GROSS        16.0
                                                                       PMR/RICHARD CROWE      16.0

  Special Reports for Projects     8-19-88  9-09-88     15             UES/IRENE WARD        120.0

DEVELOPMENT

 LOAN FILE CONVERSION

  Define Affected Data Elements    8-22-88  8-22-88      1             UES/BOB BEVERS          4.0                   2
    --Data Dictionary (30 Elements)                                    UES/DEBRA SMITH         8.0
                                                                       UES/DOUG THIELEN        8.0
                                                                       UES/LISTA ELLIOT        4.0
                                                                       UES/LORI [illegible]    4.0
                                                                       PMR/JULIE REEVES        8.0
                                                                       UES/SAL [illegible]     8.0

  Define Business Requirements     8-22-88  8-24-88      3             UES/RICH LORITSCH       8.0
    --Functional Requirements Def                                      PMR/JULIE REEVES       16.0
                                                                       UES/BOB BEVERS          8.0
                                                                       CSLFC/TRENT [illegible] 8.0

  Define Compliance Requirements   8-22-88  8-24-88      3             UES/LARRY VAN VILLI    24.0
    --Functional Requirements Doc                                      PMR/JULIE REEVES        8.0
```

Status Code Change Program

Original dates and Usage

```
-----------------Name------------------  Start    End   Duration Status --------Resource assignments--------  Float Pty Category
                                                        Bus days        Name                 Usage     Cost

                                                                        UES/KATIE             24.0
                                                                        UES/LISTA ELLIOT      24.0
                                                                        PMR/PAUL JOHNSON      24.0

Obtain User Signoff                      8-24-88  8-24-88     1         PMR/JOHN ROSENFELD     2.0                2
                                                                        PMR/JERRY GROSS        2.0
                                                                        UES/BOB BEVERS         2.0
                                                                        UES/RICH LORITSCH      2.0
                                                                        UES/LARRY VAN VILLI    2.0

Develop Program Specifications           8-25-88  8-25-88     1         PMR/JULIE REEVES       8.0                2
                                                                        UES/BOB BEVERS         4.0
                                                                        UES/DEBRA SMITH        8.0
                                                                        UES/GREG THIELEN       8.0

Determine Test Data Requirements         8-25-88  8-26-88     2         PMR/JULIE REEVES      12.0                7
                                                                        UES/RIQUI SEGOVIS     12.0
                                                                        UES/LORI BOOKOUT       3.0
                                                                        UES/LARRY VAN VILLI    4.0
                                                                        UES/MICHELE NIVELY     4.0
                                                                        UES/DAVID GONZALES     6.0

Program Loan File Conversion             8-29-88  9-01-88     3         UES/DEBRA SMITH       30.0                2
  --Conversion Programs                                                 UES/GREG THIELEN      30.0
                                                                        PMR/JULIE REEVES      16.0
                                                                        UES/BOB BEVERS         4.0

Test Conversion Program                  8-30-88  9-01-88     3         UES/LORI BOOKOUT       6.0                5
                                                                        UES/RIQUI SEGOVIS     24.0
                                                                        PMR/JULIE REEVES      12.0
                                                                        UES/BOB BEVERS         6.0
                                                                        UES/LARRY VAN VILLI    6.0
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Original dates and Usage

```
---------------Name---------------  Start    End    Duration Status  --------Resource assignments--------  Float Pty Category
                                                    Bus days         Name                  Usage     Cost

                                                                     UES/RICH LORITSCH      2.0
                                                                     UES/QUALITY ASSURAN    8.0

  Obtain User Signoff               9-01-88  9-01-88     1           PMR/JOHN ROSENFELD     2.0                5
                                                                     PMR/JERRY GROSS        2.0
                                                                     UES/BOB BEVERS         2.0
                                                                     UES/RICH LORITSCH      2.0
                                                                     UES/LARRY VAN VILLI    2.0

STATUS CODE CHANGE PROGRAM

  DAD Define/Identify all affected  8-19-88  8-22-88     3           UES/RACHELE ADLER      4.0                3
  fields                                                             UES/LIETA ELLIOT       1.0
    --Data Dictionary Elements                                       UES/BOB BEVERS         1.0

  DBD List program functions/conditio 8-18-88 8-22-88    3           UES/RACHELE ADLER     24.0                3
  ns
    --Program Logic Chart

  Define Compliance Requirements    8-19-88  8-22-88     2           UES/RICH LORITSCH     16.0
                                                                     UES/LARRY VAN VILLI   16.0
                                                                     UES/LIETA ELLIOT       8.0
                                                                     PMR/PAUL JOHNSON       4.0

  Define Business Requirements      8-23-88  8-25-88     3           PMR/JULIE REEVES      16.0                3
    --Status Code Change Rqmts                                       UES/RACHELE ADLER      8.0
                                                                     UES/BOB BEVERS         6.0
                                                                     UES/LIETA ELLIOT       4.0
                                                                     UES/DAVID GONZALES     8.0
                                                                     UES/JEFF GILMER       16.0
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| AUG 19 88                    ACTIVITY  DETAIL                      PAGE   5 |
|                                                                             |
|                        Status Code Change Program                           |
 -----------------------------------------------------------------------------

                            Original dates and Usage

-----------------Name-----------------  Start     End   Duration  Status  ---------Resource assignments---------  Float Pty Category
                                                         Num days          Name                  Usage     Cost


Obtain User Signoff                    8-25-88  8-25-88     1              PMN/JERRY GROSS         2.0                12
                                                                           UES/BOB BEVERS          2.0
                                                                           UES/RICH LORITSCH       2.0
                                                                           UES/LARRY VAN WILLI     2.0
                                                                           PMN/JOHN ROSENFILD      2.0

Develop Additional Program             8-26-88  8-26-88     1              PMN/JULIE REEVES        8.0                 3
Specifications                                                             UES/BOB BEVERS          4.0
  --Program Specifications                                                 UES/RACHELE ADLER       8.0

Determine Test Data Requirements       8-29-88  8-30-88     2              PMN/JULIE REEVES       12.0                 6
  --Test Script/Cases                                                      UES/LORI BOOKOUT        1.0
                                                                           UES/JEFF KILMER        12.0
                                                                           UES/DAVID GONZALES      3.0

Program Additional Requirements        8-29-88  9-02-88     5              UES/RACHELE ADLER      40.0                 3
                                                                           PMN/JULIE REEVES        4.0

Develop Training Materials             8-31-88  9-02-88     3              PMN/JULIE REEVES       16.0
                                                                           PMN/RICHARD CROWE       8.0
                                                                           UES/RICH LORITSCH      16.0

Test Status Code Change Program        8-31-88  9-07-88     5              UES/RACHELE ADLER       4.0                 2
                                                                           PMN/JULIE REEVES       16.0
                                                                           UES/LORI BOOKOUT        4.0
                                                                           UES/LARRY VAN WILLI     6.0
                                                                           UES/BOB BEVERS          6.0
                                                                           UES/RICH LORITSCH       4.0
                                                                           UES/LORI BOOKOUT        4.0
                                                                           UES/DAVID GONZALES     16.0
```

Original dates and Usage

```
-----------------Name-----------------   Start    End    Duration  Status  --------Resource assignments--------  Float Pty Category
                                                         Bus days          Name                 Usage      Cost

  Obtain User Signoff                   9-07-88  9-07-88     1              PMR/JERRY GROSS       2.0                   2
                                                                            UES/BOB BEVERS        2.0
                                                                            UES/RICH LORITSCH     2.0
                                                                            PMR/JOHN ROSENFELD    2.0

HOLD FILE CONVERSION

  DAD Define Affected Data Elements     8-18-88  8-19-88     2              UES/RIQUI SEDORIS     8.0
    --Data Dictionary Elements                                              PMR/MIKE SURFACE     16.0
                                                                            UES/LIETA ELLIOT      8.0
                                                                            UES/JEFF MILNER       8.0

  Define Conversion Requirements        8-19-88  8-22-88     2              UES/RIQUI SEDORIS     8.0                   1
    --Functional Requirements Doc                                           PMR/MIKE SURFACE     16.0
                                                                            UES/BOB BEVERS        4.0
                                                                            UES/JEFF MILNER       8.0
                                                                            UES/LORI BOSHOUT      2.0

  Obtain User Signoff                   8-22-88  8-22-88     1              PMR/JOHN ROSENFELD    2.0                   1
                                                                            PMR/JERRY GROSS       2.0
                                                                            UES/BOB BEVERS        2.0
                                                                            UES/RICH LORITSCH     2.0
                                                                            UES/LARRY VAN WILLI   2.0

  Develop Program Specifications        8-22-88  8-22-88     1              PMR/MIKE SURFACE      8.0                   1
    --Program Specifications                                                UES/BOB BEVERS        4.0
                                                                            UES/REX MILLER        8.0
                                                                            UES/DEBRA SMITH       4.0

  Determine Test Data Requirements      8-23-88  8-24-88     2              PMR/MIKE SURFACE     12.0                   3
    --Test Script                                                           UES/RIQUI SEDORIS     6.0
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-----------------------------------------------------------------------------
| AUG 19 88                ACTIVITY  DETAIL                        PAGE   7 |
|                                                                           |
|                       Status Code Change Program                          |
-----------------------------------------------------------------------------

                        Original dates and Usage

-----------------Name-----------------  Start     End  Duration  Status  ---------Resource assignments---------  Float Pty Category
                                                       Bus days          Name                 Usage       Cost

                                                                         UES/JEFF MILNER        6.0

   Program Hold File Conversion        8-24-88  8-30-88    5             UES/REX MILLER        32.0                   1
     --Conversion Program                                                PMR/MIKE SURFACE       8.0

   Test Conversion Program             8-26-88  9-01-88    5             PMR/MIKE SURFACE      32.0                   2
     --Completed Test Script                                             UES/LORI BOOKOUT       4.0
                                                                         UES/LARRY VAN WILLI    6.0
                                                                         UES/BOB BEVERS         6.0
                                                                         UES/RICH LORITSCH      4.0
                                                                         UES/MICHELE HIVELY    18.0
                                                                         UES/QUALITY ASSURAN   10.0

   Obtain User Signoff                 9-01-88  9-01-88    1             PMR/JOHN ROSENFELD     2.0                   2
                                                                         PMR/JERRY GROSS        2.0
                                                                         UES/BOB BEVERS         2.0
                                                                         UES/RICH LORITSCH      2.0

HOLD FILE BACKLOG UPDATE PROGRAM

   Define Functional Requirements      8-22-88  8-25-88    4             PMR/PAUL JOHNSON      12.0                   0
     --Functional Requirements Doc                                       UES/RIGUI SEDORIS      6.0
                                                                         UES/JEFF MILNER        6.0
                                                                         UES/BOB BEVERS         4.0
                                                                         UES/LORI BOOKOUT       2.0

   Define Compliance Requirements      8-22-88  8-24-88    3             PMR/PAUL JOHNSON       8.0
     --Functional Requirements Doc                                       UES/LARRY VAN WILLI    8.0
                                                                         UES/LIETA ELLIOT       4.0

   Obtain User Signoff                 8-25-88  8-25-88    1             PMR/JERRY GROSS                              0
                                                                            8-25-88      1      2.0
```

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| AUG 19 88                ACTIVITY  DETAIL               PAGE   8 |
|                                                                  |
|                      Status Code Change Program                  |
 -----------------------------------------------------------------

                        Original dates and Usage

----------------Name------------------  Start    End   Duration  Status  --------Resource assignments--------  Float Pty Category
                                                        Bus days         Name                Usage      Cost

                                                                         UES/BOB BEVERS
                                                                           8-25-88       1     2.0
                                                                         UES/RICH LORITSCH
                                                                           8-25-88       1     2.0
                                                                         PMR/JOHN ROSENFELD    2.0
                                                                         UES/LARRY VAN WILLI   2.0

  Develop Program Specifications      8-26-88  8-26-88      1            PMR/PAUL JOHNSON      8.0                   0
    --Program Specifications                                             UES/BOB BEVERS        4.0
                                                                         UES/GREG THIELEN      4.0
                                                                         UES/REX MILLER        4.0

  Determine Test Data Requirements    8-26-88  8-29-88      2            PMR/PAUL JOHNSON     12.0                  15
                                                                         UES/RIQUI SEDORIS     6.0
                                                                         UES/JEFF MILNER       6.0
                                                                         UES/LORI BOOKOUT      4.0

  Program Backlog Processing System   8-26-88  9-01-88      5            UES/REX MILLER       18.0                   0
                                                                         PMR/PAUL JOHNSON      4.0

  Develop Manual Processing           9-02-88  9-09-88      5            PMR/PAUL JOHNSON      8.0
  Procedures                                                             UES/RIQUI SEDORIS     8.0
                                                                         UES/JEFF MILNER       8.0
                                                                         UES/LARRY VAN WILLI   4.0

  Test Backlog Update Program         8-30-88  9-06-88      5            PMR/PAUL JOHNSON     10.0                   0
                                                                         UES/RIQUI SEDORIS     9.0
                                                                         UES/LORI BOOKOUT      2.0
                                                                         UES/MICHELE NIVELY    9.0
                                                                         UES/DAVID GONZALES   11.0
```

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---------------------------------------------------------------------------------------
| AUG 19 88                    ACTIVITY  DETAIL                            PAGE   9 |
|                                                                                   |
|                          Status Code Change Program                               |
---------------------------------------------------------------------------------------

                                Original dates and Usage

                                                              --------Resource assignments--------  Float Pty Category
----------------Name----------------   Start    End    Duration Status  Name                 Usage      Cost
                                                       Bus days

  Obtain User Signoff                  9-06-88  9-06-88    1             PMR/JERRY GROSS       2.0                      0
                                                                         UES/BOB BEVERS        2.0
                                                                         UES/RICH LORITSCH     2.0
                                                                         PMR/JOHN ROSENFELD    2.0
                                                                         UES/LARRY VAN WILLI   2.0

FINANCIAL PROGRAMS CASH
  UPDATE/RECOVERIES

  Define Functional Requirements       8-22-88  8-25-88    4             PMR/RICHARD CROWE    24.0
    --Functional Requirements Doc                                        UES/JULIE PFAUTZ     24.0
                                                                         UES/BOB BEVERS        4.0

  Define Compliance Requirements       8-22-88  8-24-88    3             PMR/PAUL JOHNSON      8.0
    --Functional Requirements Doc                                        UES/LARRY VAN WILLI   8.0
                                                                         UES/LIETA ELLIOT      8.0

  Obtain User Signoff                  8-25-88  8-25-88    1             PMR/JOHN ROSENFELD
                                                                           8-25-88      1      2.0
                                                                         PMR/JERRY GROSS
                                                                           8-25-88      1      2.0
                                                                         UES/BOB BEVERS
                                                                           8-25-88      1      2.0
                                                                         UES/RICH LORITSCH
                                                                           8-25-88      1      2.0
                                                                         UES/LARRY VAN WILLI   2.0

  Develop Program Specifications       8-26-88  8-26-88    1             PMR/RICHARD CROWE     8.0
    --Program Specifications                                             UES/BOB BEVERS        4.0
                                                                         UES/GREG THIELEN      8.0
                                                                         UES/DEBRA SMITH       8.0
```

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| AUG 19 88                ACTIVITY  DETAIL                  PAGE  10 |
|                     Status Code Change Program                      |
 ---------------------------------------------------------------------

                        Original dates and Usage

-------------Name-------------  Start    End    Duration  Status  --------Resource assignments--------  Float Pty Category
                                                Bus days          Name                  Usage     Cost


  Determine Test Data Requirements  8-25-88  8-26-88    2         PMR/RICHARD CROWE      12.0
    --Test Script                                                 UES/JULIE PFAUTZ       12.0
                                                                  UES/LORI DOORNOUT       6.0
                                                                  UES/MICHELE HIVELY      4.0
                                                                  UES/QUALITY ASSURAN     4.0

  Program Financial Applications    8-29-88  9-01-88    3         UES/DEBRA SMITH        14.0
                                                                  UES/GREG THIELEN       16.0
                                                                  PMR/RICHARD CROWE       4.0

  Test Financial Programs           8-30-88  9-06-88    5         PMR/RICHARD CROWE      18.0
                                                                  UES/JULIE PFAUTZ       18.0
                                                                  UES/LORI DOORNOUT       2.0
                                                                  UES/MICHELE HIVELY     10.0
                                                                  UES/QUALITY ASSURAN    10.0

  Obtain User Signoff               9-06-88  9-06-88    1         PMR/JOHN ROSENFELD      2.0
                                                                  PMR/JERRY GROSE         2.0
                                                                  UES/BOB BEVERS          2.0
                                                                  UES/RICK LORITSCH       2.0
                                                                  UES/LARRY VAN WILLI     2.0

IMPLEMENTATION

  Run Conversion Programs           9-07-88  9-07-88    1         PMR/JOHN ROSENFELD      2.0
                                                                  UES/BOB BEVERS          2.0

  Implement New Programs            9-07-88  9-07-88    1         PMR/JOHN ROSENFELD      2.0
                                                                  UES/BOB BEVERS          2.0
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| AUG 19 88              ACTIVITY  DETAIL                  PAGE  11 |
|                                                                    |
|                   Status Code Change Program                       |
 ---------------------------------------------------------------------

                    Original dates and Usage

----------------Name----------------  Start    End   Duration Status  --------Resource assignments--------  Float Pty Category
                                                    Bus days        Name            Usage        Cost

Total project                         8-16-88 9-29-88               Total hours     1891.0
```

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---------------------------------------------------------------------------------
| AUG 19 88                    ACTIVITY  DETAIL                       PAGE  12 |
|                                                                              |
|                       Status Code Change Program                              |
---------------------------------------------------------------------------------

                                    Original dates and Usage

------------------Name------------------   Start     End    Duration Status  ---------Resource assignments--------- Float Pty Category
                                                             Bus days         Name                  Usage     Cost

Resource summary

    Name

PMR/JOHN ROSENFELD                       8-16-88  9-09-88                    P-JR                   53.0
PMR/JERRY GROSS                          8-16-88  9-09-88                    P-JG                   41.0
UES/RICH LOEITSCH                        8-16-88  9-07-88                    U-RL                   80.0
UES/RON BEVERS                           8-16-88  9-07-88                    U-RB                  120.0
PMR/JULIE REEVES                         8-16-88  9-07-88                    P-JR                  156.0
UES/PROGRAMMER-ANA                                                           U-PA
UES/RACHELE ADLER                        8-18-88  9-07-88                    U-RA                   88.0
UES/LARRY VAN VILL                       8-19-88  9-09-88                    U-LV                   98.0
PMR/RICHARD CRONE                        8-16-88  9-09-88                    P-RC                  116.0
UES/LIETA ELLIOT                         8-17-88  8-25-88                    U-LE                   83.0
UES/DEBRA SMITH                          8-17-88  9-01-88                    U-DS                   96.0
UES/GREG THIELEN                         8-17-88  9-01-88                    U-GT                   96.0
UES/SAL BORELLO                          8-17-88  8-22-88                    U-SB                   30.0
UES/RIQUI SEGURIS                        8-18-88  9-09-88                    U-RS                   93.0
PMR/PAUL JOHNSON                         8-19-88  9-09-88                    P-PJ                  106.0
UES/LORI BOOKOUT                         8-19-88  9-07-88                    U-LB                   44.0
UES/REX MILLER                           8-17-88  9-01-88                    U-RM                   76.0
UES/JULIE PFAUTZ                         8-22-88  9-06-88                    U-JP                   54.0
PMR/MIKE SURFACE                         8-17-88  9-01-88                    P-MS                  114.0
UES/IRENE WARD                           8-19-88  9-09-88                    U-IW                  120.0
CSLFC/TRENT WEBBER                       8-22-88  8-24-88                    C-TW                    8.0
UES/KATIE                                8-22-88  8-24-88                    U-K                    24.0
UES/JEFF HILMER                          8-18-88  9-09-88                    U-JH                   76.0
UES/MICHELE HIVELY                       8-25-88  9-06-88                    U-MH                   45.0
UES/DAVID GONZALES                       8-23-88  9-07-88                    U-DG                   44.0
UES/QUALITY ASSURA                       8-23-88  9-06-88                    U-QA                   32.0
```

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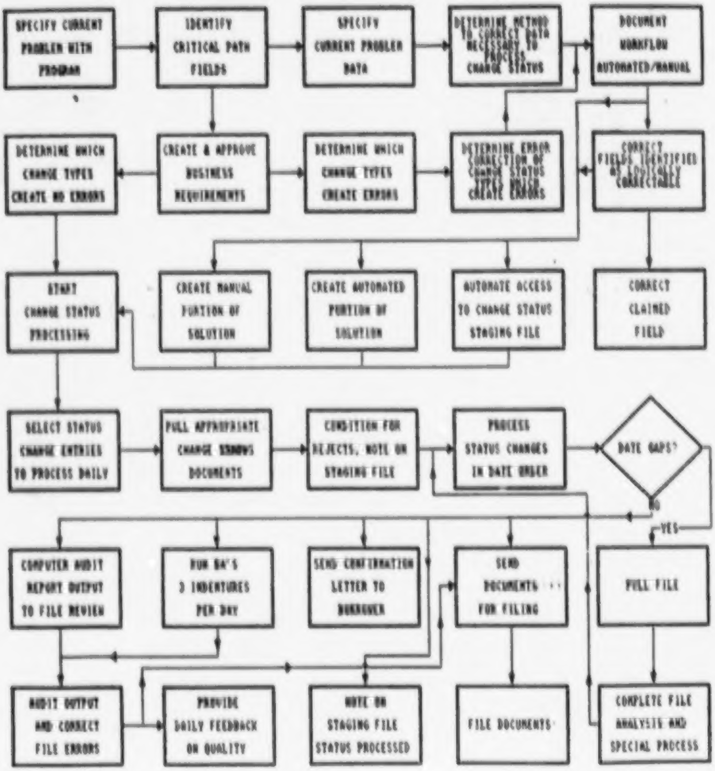
| AUG 19 88                  ACTIVITY  DETAIL                     PAGE  13 |
|                                                                          |
|                        Status Code Change Program                        |
 ----------------------------------------------------------------------------

                          Original dates and Usage

----------------Name----------------  Start    End   Duration Status --------Resource assignments-------- Float Pty Category
                                                     Bus days        Name               Usage       Cost

Total project                         8-16-88 9-29-88                Total hours        1893.0
```

CHANGE STATUS CORRECTION PROCESS OVERVIEW


SPECIFY CURRENT PROBLEM WITH PROGRAM
IDENTIFY CRITICAL PATH FIELDS
SPECIFY CURRENT PROBLEM DATA
DETERMINE METHOD TO CORRECT DATA NECESSARY TO PROCESS CHANGE STATUS
DOCUMENT WORKFLOW AUTOMATED/MANUAL
DETERMINE WHICH CHANGE TYPES CREATE NO ERRORS
CREATE & APPROVE BUSINESS REQUIREMENTS
DETERMINE WHICH CHANGE TYPES CREATE ERRORS
DETERMINE ERROR CORRECTION OF CHANGE STATUS TYPES WHICH CREATE ERRORS
CORRECT FIELDS IDENTIFIED AS LOGICALLY CORRECTABLE
START CHANGE STATUS PROCESSING
CREATE MANUAL PORTION OF SOLUTION
CREATE AUTOMATED PORTION OF SOLUTION
AUTOMATE ACCESS TO CHANGE STATUS STAGING FILE
CORRECT CLAIMED FIELD
SELECT STATUS CHANGE ENTRIES TO PROCESS DAILY
PULL APPROPRIATE CHANGE [illegible] DOCUMENTS
CONDITION FOR REJECTS, NOTE ON STAGING FILE
PROCESS STATUS CHANGES IN DATE ORDER
DATE GAPS?
NO
YES
COMPUTER AUDIT REPORT OUTPUT TO FILE REVIEW
RUN BA'S 3 INDENTURES PER DAY
SEND CONFIRMATION LETTER TO BORROWER
SEND DOCUMENTS FOR FILING
PULL FILE
AUDIT OUTPUT AND CORRECT FILE ERRORS
PROVIDE DAILY FEEDBACK ON QUALITY
NOTE ON STAGING FILE STATUS PROCESSED
FILE DOCUMENTS
COMPLETE FILE ANALYSIS AND SPECIAL PROCESS

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PROCEDURE/ACTION PLAN

TITLE: STATUS CHANGE CORRECTION OVERVIEW   IDENTIFIER: CHSTATUS

RESULTS EXPECTED: TO CREATE A PROCESS THAT ALLOWS LOANS TO REFLECT THE PROPER "STATUS" SO THAT ACCURATE DUE DILIGENCE CAN BE PERFORMED. THIS PROCESS INCLUDES THE PROCESSING OF ALL CURRENT BACKLOGGED STATUS CHANGES AND THE CORRECTION OF ANY RESULTING ERRORS TO THE FILE.

ORGANIZATION UNIT WITH OVERALL RESPONSIBILITY: SPECIAL TASK GROUP ESPECIALLY FOR THE ABOVE TASK.

POSITION WITH OVERALL ACCOUNTABILITY: SPECIAL TASK GROUP LEADER

BENCHMARKS	ACCOUNTABLE	DUE BY
1. CREATE BUSINESS REQUIREMENTS DOCUMENT		
2. DETERMINE CURRENT STATUS OF SOFTWARE		
3. DETERMINE CURRENT STATUS OF BACKLOG		
4. DETERMINE CURRENT STATUS OF DATA		
5. CREATE PLAN TO ACHIEVE TASK		
6. OBTAIN RESOURCES TO EXECUTE PLAN		
7. CODE AND TEST AUTOMATED PORTION OF PLAN		
8. DOCUMENT MANUAL SUPPORT SYSTEM		
9. CORRECT KEY DATA FIELDS IN DATABASE		
10. DETERMINE ORDER AND PROCESS CHANGE STATUS		
11. SEND CONFIRMATION LETTERS TO BORROWERS		
12. AUDIT RESULTS AND CORRECT FILE ERRORS		
13. FILE COMPLETED DOCUMENTS		
14. CORRECT ZIP CODE TABLE		
15. CODE AND RUN TRANS UNION TAPE AGAINST FILE		
16. LAST KNOWN ADDRESS FIELD CLEANED UP		
17. BORROWER CAN NOW BE SERVICED CORRECTLY		

STATUS CODE PROJECT KICKOFF MEETING
AUGUST 19, 1988
MINUTES

I Project Introduction - John Rosenfeld (PMM)

- Introduction of Lee Benedict, new Vice President and General Manager of Data Services Division - Costa Mesa

II Project Background - Jerry Gross (PMM)

- Handout 1
- Project goal is to understand 65% - 75% of all status code data in loan portfolios by mid - September
- This understanding will demonstrate that UES is capable of servicing their portfolios
- This project will not put UES in compliance

III Project Plan - Bob Beavers (UES)

- Handout 2
- Display Charts

Areas Reviewed

A Project Overview

- Explanation of Status Code Change
- Description of files used in Status Code Change

B Database File Corrections (Debbie Smith and Greg Thielen)

- Overview of project plan including critical files and fields
- The issue of Interest Billing and Special Allowance is targeted to be operational by the end of the quarter (Oct.)

C Change of Status Program (Rachele Adler)

- Overview of project plan including examples of status code changes
- Manifests were excluded from the scope of this project
- The issue of implementing modified programs as they become operational was discussed and was referred to management
- Due to time constraints test data will be developed for the scope of this project only

STATUS CODE PROJECT KICKOFF MEETING
AUGUST 19, 1988
MINUTES

D Hold File (Rex Miller and Mike Surface)

- Overview of project plan including explanation of the creation and purpose of the hold file

E Cash Update (Sal Monello)

- Overview of project plan including ledger examples
- It was determined that 50% of all cash payments require a manual decision making process

F Electronic Recoveries (Greg Thielen)

- Overview of project plan including explanation of Electronic Transfers
- The issue of defining the format and content of Electronic Recoveries was discussed and unresolved

G Other Areas Addressed Included:
- Claims
- Review and Analysis
- Testing
- Documentation

IV Group Exercise

Things to Remember

- Even the most detailed project plans can be changed by unforeseen events
- Calm, rational reaction to unforeseen project change will provide the best results

V Schedule

- Next scheduled meeting is Monday, August 22 at 8:00 am
- Weekly project status meetings will be held every Friday

UES

UNITED EDUCATION & SOFTWARE
DATA SERVICES DIVISION

STUDENT LOAN SERVICING
TECHNICAL RECOVERY PROGRAM
MANAGEMENT OVERVIEW

Resource Comment:

UES/DSD currently has sufficient human and technical resources on board to execute the program as presented with the exception that additional disk storage capacity is required and will be procured when defined. Additional recruiting is on-going to increase management depth, reduce dependence on consultants, and prepare for future growth. Priority requirements exist in accounting and human resources management. Technical support from PM&M is expected to continue for at least three to six months. Important outstanding requisitions also exist in the compliance function.

Procedures Comment:

The basic procedures for Due Diligence compliance have been put in place. These procedures need to be tightened by documentation, audit, and refinement.

Technology/Equipment Comment:

Security and resource capacity has been increased by the installation of a second IBM System/38. Additional disk storage requirements are being defined for purchasing. The ITC automatic due diligence outgoing phone equipment has not been operating reliably or satisfactorily as guaranteed by the manufacturer. Additional phone equipment and overflow operators are being put in place consistent with our internal goal of eliminating the occurrence of borrowers being placed on hold.

Independent Audit Comment:

UES/DSD is interviewing "Big 8" auditing firms to select one (other than PM&M) to monitor, audit, and validate this recovery program.

UES

PHASE I
STATUS CODE

SCHEDULED COMPLETION: SEPTEMBER 12, 1988

This project has three objectives, all of which are aimed at restoring order to the collection and billing efforts.

1. Correct the Critical Application Software Programs: Change of Status, Cash Update, Electronic Recoveries.

   The routine procedure of updating student status originally became backlogged and then was put on hold when it was discovered that the new application software in the above three programs was improperly handling date and balance fields in the data base. A very substantial effort with the full involvement of PM&M has been underway to correct these programs to properly reflect all regulations and procedures from the Government and Guarantors. The Electronic Recovery program, which changes appropriate file data to reflect that a student has made a loan refund after early course termination, has been completed and tested. In the Change of Status program, 19 of the 30 "flips" (Grace to Repayment, for example) have been completed and tested. The remaining 11 status "flips" plus the Cash Update program will be completed this week.

2. Update the Change Status Hold File.

   A massive manual effort is underway to make sure that all of the information in the Student Status Hold file is updated to reflect the latest information available from the Guarantors and the schools. This project includes the visual review of 72,000 school letters and 100,000 repayment schedules which was totally completed over Labor Day weekend by 100+ overtime volunteers. The effort will prepare the "Hold" file so that it can be integrated into the data base by Sepember 12, 1988. Individual accounts which have conflicting or incomplete information will be set aside for reverification with the schools. The magnitude of the reverification effort will be known during the week of September 12, 1988.

3. Update the Data Base with the Cleansed Hold File.

   On September 12, 1988, the corrected "Hold" file will be processed into the data base correcting the Student Status Code. This will cause collection efforts (calls, letters, skip-tracing, etc.) to properly reflect the correct student status. Furthermore, it will allow IB and SAP billings to proceed from an operations point of view, although the exact financial balances will not be verified and adjusted until Phase III is completed as discussed below.

PHASE II
DUE DILIGENCE COMPLIANCE

SCHEDULED COMPLETION: SEPTEMBER 30, 1988

While the Change of Status project will fundamentally restore order to collection and billing, full Due Diligence Compliance cannot be assured until each loan has the proper information in the date fields (exit date; payment amount date; next payment due date; interest paid to date; ledger cash transaction dates; ledger correspondence transaction dates). These date fields are in the existing data base and can be electronically validated against the historical record. The validation algorithms are being designed to compensate for past software errors and check the fields for reasonableness against standards established by PM&M. Accounts not passing this test will be kicked out into an exception file for manual correction. We are not yet able to estimate the size of the exception file, but we are prepared to commit the application of the necessary resources required to complete the exception file by October 30, 1988.

In addition to the date field verification, Phase II of the program also includes a correction to the faulty zip code program and tables, as is required to reduce the returned mail occurrence.

When Phase II is complete on September 30, 1988, UES/DSD will be ready to start recycling due diligence in full compliance. This recycling will permit each borrower to re-establish a proper payment schedule. During this period, the borrower will be given "amnesty" as relates to their credit rating. The loans covered would be those in delinquent status or claims status at the Guarantor and loans already paid by the Guarantor that are in question by the Guarantor. We believe that valid questions do pertain to loans which were still subject to due diligence after September, 1987. Authorization for this approach is required by September 25, 1988, in order to commence recycling on October 1, 1988.

PHASE III
IB AND SAP ADJUSTMENTS

SCHEDULED COMPLETION: DECEMBER 30, 1988

Once the date fields are verified so that we can achieve full compliance, the final step in the data base cleanup is to verify and/or correct the financial balances in each account. Special programs will be written to electronically verify the balance fields against the histories. As in Phase II, PM&M will establish program criteria for reasonableness which will kick out problem accounts into an exception file. Since the programs will be designed with the past errors in mind, we have no reason to fear that the exception file will be unmanageable. The exception file will be processed semi-automatically against the historical tapes in archive storage. If that does not resolve an account's problems, it will be manually corrected by December 30, 1988.

Concurrent with the balance field updates, UES/DSD will institute a "Monthly Billing" procedure in order to make sure that multiple account borrowers will have their payments properly allocated. A "Lock Box" system will be installed to hasten cash handling. Additionally, a microfilm access system will be installed to facilitate claims and audits.

Achievement of Phase III goals by December 30, 1988, will allow UES/DSD to apply appropriate debits and credits to previously submitted IB, SAP, and Claim amounts. By December 30, 1988, the entire system will be functioning properly and in accordance with all regulations.

During Phase III, UES/DSD will also beef up its collection activities with the aim of going well beyond Due Diligence requirements and establishing a new standard for collections. For example, while Due Diligence may require two phone calls in a month, aggressive collection practices would never allow a delinquent borrower to sit on telephone "hold". UES/DSD has a program to eliminate telephone "holds" before October, 1988.

PHASE IV
NEW LOANS

UES/DSD is not taking any new loans at the present time. Obviously, in order to provide a continuing student loan service, the Division must be a going concern with a living portfolio. The guideline for accepting new loans from CSLFC is that UES/DSD must be able to process them 100% accurately and must prepare for their acceptance on a not-to-interfere basis with Phases I-III of the reconstruction program. Within those guidelines, UES/DSD will be ready to accept new loans from CSLFC as follows:

PHASE IV
NEW LOANS
(contd.)

Date	Quantity of New Loans
October 30, 1988	First One
November 30, 1988	50% of 1987 Rate
December 30, 1988	100% of 1987 Rate

In executing Phases I-IV, UES/DSD will be drawing upon UES Corporate financial and management resources which have been committed as required. Additionally, PM&M's technical consulting support will be fully involved.

The overall schedule presented here is a management commitment for which the near term activities are backed up by program details and schedules. The accomplishment dates will be protected by additional resources where required. I will announce any interruptions which threaten the schedule in time for them to be averted.

STATEMENT

TRENT G. NEBEKER, VICE PRESIDENT

CALIFORNIA STUDENT LOAN FINANCE CORPORATION

BEFORE THE

SENATE PERMANENT SUBCOMMITTEE

ON INVESTIGATION

September 26, 1990

Mr. Chairman and Members of the Subcommittee:

My name is Trent Nebeker, Vice President of California Student Loan Finance Corporation. Thank you for asking me to appear before you today.

The California Student Loan Finance Corporation was incorporated on June 23, 1980, under the nonprofit Corporation Law of the State of California as a nonprofit public benefit corporation exclusively for the purpose of making or acquiring student loans incurred under the United States Higher Education Act of 1965, as amended (the "Act").

The Corporation is a tax-exempt entity pursuant to Section 501(c)(3) of the Internal Revenue Code (the "Code") and also qualifies as an issuer of tax-exempt Qualified

Scholarship Funding Bonds pursuant to Section 150(d)(2) of the Code.

The Corporation established its student loan purchase program in order to provide a secondary market to increase the availability of funds to assist students in obtaining a post secondary education. Over the past ten years, the Corporation entered into Student Loan Purchase Agreements with over forty financial and educational institutions which qualify as eligible lenders under the Higher Education Act, providing for the purchase of eligible loans originated by the lenders.

To date, the Corporation has purchased over $2 billion of Guaranteed Student Loans. At July 31, 1990, the Corporation held a student loan portfolio totalling $1,128,972,264. The funds used to acquire such loans were derived through the issuance of both taxable and tax-exempt obligations issued pursuant to 15 discrete trust indentures.

The Corporation has loan servicing arrangements with AFSA Data Corporation, Costa Mesa Service Center (a subsidiary of AFSA) and Mitchell Sweet & Associates, providing for the servicing of all purchased eligible loans.

As an issuer of tax-exempt Qualified Scholarship Funding Bonds, the Corporation is subject to the Plan For Doing Business requirements of Section 438(d) of the Act in order for the Corporation to receive Special Allowance Payments from the Secretary. The Corporation's initial Plan was approved by the Secretary and subsequent amendments were approved by the Governor of the State of California as required by the Act. The provisions of the Plan are mandated by the Act and include the following elements:

> "(A) No eligible lender in the area served by the Authority will be excluded from participation in the program of the Authority . . .
>
> "(D) the Authority will, within the limit of funds available and subject to the applicable State and Federal law, make loans to, or purchase loans incurred by, all eligible students who are residents of, or who attend an eligible institution within, the area served by the Authority;
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> "(E) The Authority has a plan under which the Authority will pursue the development

> of new lender participation in a continuing program of benefits to students together with assurances of existing lender commitments to the program . . . ." Section 138(d)(2).

In addition, Section 138(d)(3) of the Act conditions the Corporation's eligibility to receive Special Allowance Payments upon its not engaging ". . . in any pattern or practice which results in the denial of a borrower's access to loans because of the borrower's race, sex, color, religion, national origin, age, handicapped status, income, attendance at a particular eligible institution within the area served by the Authority, length of the borrower's educational program or the borrower's academic year in school."

From its inception through the end of June 1988, the Corporation had succeeded in carrying out its mandate of expanding access of all eligible students to student loans by providing secondary market services to originators of student loans, i.e., banks, savings and loan associations, trust companies, credit unions and others designated as Eligible Lenders under the Act. As noted above, in order to receive Special Allowance Payments from the Secretary, the

Corporation was prohibited from discriminating in the purchase of its loans based upon, among other things, attendance by a student at a particular eligible institution. The Corporation was not involved in determining the eligibility of institutions--that function belongs to the Secretary.

The UES Servicing Errors. Until November 1988, a large portion of the Corporation's student loan portfolio was serviced by United Education & Software ("UES"). The Servicing Agreement with UES was terminated on November 8, 1988 as a result of servicing errors resulting in large measure from failure properly to convert servicing operations from one computer system to another which resulted in UES' failure to properly perform the "due diligence" required in student loan collection. Servicing of the former UES-serviced portfolio was transferred to Costa Mesa Service Center, Inc. ("CMSC"), a subsidiary of AFSA Data Corporation, another of the Corporation's servicers.

Prior to the disclosure in June 1988 of the UES servicing breakdown, CSLFC reasonably believed that UES was complying with its collection due diligence duties, because (i) UES hired a new manager of the service center in whom the Corporation had faith; (ii) the Corporation was assured by UES that all servicing problems were being resolved; and (iii) UES was audited by Peat Marwick Main & Co. and others, and such auditors had advised the Corporation that UES's due diligence performance was in substantial compliance with the Department's regulations.

The Department of Education (the "Department") advised that it would strictly enforce the Department's loan servicing due diligence requirements and its March 1988 cure bulletin. In addition, the Department has required, among other things, the repurchase of any student loan for which claims were previously paid based on erroneous information regarding collection activity. These account violations, resulting from the UES servicing deficiencies, are not all curable in accordance with the March 1988 bulletin; and not all of the loans for which a cure procedure is available are expected to be cured. Uncured loans are expected to have little or no value. Each of the Corporation's indentures of trust is expected to bear material losses. In addition, the Corporation has suffered and will continue to suffer substantial losses of revenue due to certain action taken by the Department and the Guarantors with respect to payment of Special Allowance Payments and accrued borrower interest.

FIT Problems. The Corporation's indentures have incurred certain losses due to the insolvency of First Independent Trust Company ("FIT"), a former Seller of Student Loans which is currently in the process of liquidation by the Superintendent of Banks of the State of California. The most significant categories of these losses include: Guarantee fees required to be paid from the indentures due to nonpayment by FIT; Origination fees required to be paid from the indentures due to nonpayment by FIT; cancellations and refunds of loans purchased from FIT for which funds were not returned to the indentures; unreimbursed transfer fees paid on loans purchased from FIT which were subsequently cancelled; and improperly originated loans. Litigation concerning these and other matters is pending between the Corporation and FIT; it appears, however, that settlement of this suit is imminent.

HEAF Problems. HEAF has refused to honor certain Guarantee claims submitted by CMSC for loans which have been cured in accordance with the Department's March 1988 bulletin. We are hopeful that the Department's efforts to resolve HEAF's financial difficulties will result in a quick resumption of HEAF claims payments; continued non-payment of such claims continues to cause material losses to the Corporation's indentures.

__Conclusion__. Because of the Corporation's problems involving UES, FIT, HEAF and others, the Corporation is not presently purchasing student loans. We look forward to a speedy resolution of these matters so that the Corporation can resume providing secondary market services to the student loan community.

RESPONSES TO FOLLOW-UP QUESTIONS

Trent G. Nebeker, Vice President
California Student Loan Finance Corporation

1. Question:

CSLFC issued bonds to raise capital for the purchase of student loans, and backed those bonds with student loans as collateral. Many of these loans were later cancelled or suffered due diligence exceptions which have resulted in the loss of the guarantee. What has happened to the value of the bonds - what were they being traded at, and what are they being traded at today?

Answer:

CSLFC raised capital by issuing its obligations under various indentures of trust. The trust assets secure the obligations. The trust assets include student loans, cash and investment securities. In addition to the trust assets the obligations are also secured by direct draw letters of credit from highly rated banks. Because the obligations are in effect guaranteed not only by the trust assets but also by letters of credit from highly rated banks, the obligations trade virtually the same as the obligations of the letter of credit bank. Although it is true that because of the loss of the guarantee on many of the student loans the trust assets themselves are inadequate to fully retire the obligations issued under the indentures, nonetheless, because the letters of credit remain in place those obligations still trade at only a slight premium above comparable letter of credit backed paper. When the bonds mature and are paid by the letter of credit banks, there will be insufficient assets in the indentures to fully reimburse the letter of credit banks (subject to possible recoveries obtained by litigation).

2. Question:

Did CSLFC make a habit of knowingly buying "bad" loans in order to get a bank's "good" loans?

Answer:

"Eligible Loans", i.e., those incurred under the Higher Education Act of 1965, as amended, and entitled to federal benefits thereunder, are neither "good" nor "bad"; higher balance, longer term loans are, however, more "profitable" than lower balance, shorter term loans. The term of a loan is affected by the length of the curriculum of the student, the likelihood that the student may pursue an advanced or further degree, the likelihood that the student may fail to complete the curriculum and the likelihood that the student may default during the repayment period. By statute and regulation, an Authority (like the Corporation) utilizing proceeds of tax-exempt financing must ". . . purchase loans incurred by all eligible students who are residents of, or who attend an eligible institution within, the area served by the Authority; . . . ." Higher Education Act Section 438(d)(2)(D). Furthermore, Section 438(d)(3) states that any Authority which issues tax-exempt obligations (without regard to whether the loans were purchased with proceeds of tax-exempt or taxable obligations) ". . . shall not engage in any pattern or practice which results in a denial of a borrower's access to loans under this part because of the borrower's . . . attendance at a particular eligible institution within the area served by the Authority . . . [or] length of the borrower's educational program . . . ." Thus, so long as the Guaranty Agencies and the Department of Education chose to give Eligible Lender status to lenders making loans to students attending vocational schools which the Department also declared Eligible, CSLFC could not refuse to purchase such loans (even though they were lower balance, shorter term loans). In addition, CSLFC was established with a goal of expanding educational access to students, including low-income and trade school students, who had been underserved. CSLFC was not created for the purpose of making a profit, so it does not regard less profitable loans as "bad" if they help an eligible student to obtain an education. CSLFC sought to acquire 4-year college loans, 2-year college loans and trade school loans. However, CSLFC was unable to acquire a substantial quantity of longer term, higher balance loans in later years due to Sallie Mae's competitive advantages.

3. Question:

Approximately 90 percent of the student loans held by CSLFC were serviced by UES. What steps did CSLFC take to ensure that UES was able to properly service those loans?

Answer:

In brief, CSLFC took several steps to ensure proper servicing by each of its servicers. For example:

1. CSLFC engaged its independent auditors, Main Hurdman (and its successor Peat Marwick) to conduct "due diligence" compliance audits of all of CSLFC's servicers for every year since 1981. After CSLFC began to notice accounting discrepancies at UES in mid-1987, it expanded Peat Marwick's role and retained them to further analyze UES's internal controls, computer systems and regulatory compliance. Unfortunately, Peat Marwick's auditors and consultants failed to discover the UES due diligence failures. (See also answer to Question 4 below.)

2. As CSLFC's Vice President of Sales, Service and Marketing, I regularly met with UES management and was constantly assured of UES's ability and desire to properly service CSLFC's increasing loan volume. Nonetheless, I urged UES to hire Rich Loritsch as a consultant to review UES' operations in order to ensure UES's capacity to handle increased volume. UES hired Mr. Loritsch in August 1987 and in March 1988, I pressed UES to replace Gretchen Staff with Rich Loritsch, whom I regarded as a better manager and more capable of dealing with increased loan volume. Unfortunately, as former UES employees have stated, UES made a practice of concealing its due diligence failures from me and CSLFC. Accordingly, I was not aware of the major due diligence failures at UES until they were revealed in mid-1988. (See also answers to Questions 6 and 7 below.)

3. CSLFC relied on audits by and interaction with Guaranty Agencies, which also failed to detect unusual due diligence problems at UES or to report them to CSLFC until mid-1988.

4. Question:

The audits of UES performed by Main Hurdman, and later by Peat Marwick Main, were limited-scope audits, designed to answer only certain questions. Was a complete audit of UES's operations ever performed for CSLFC? If not, why not?

Answer:

The audits of UES performed by Main Hurdman, and later by Peat Marwick Main & Co., were not limited-scope audits. The audits were intended to be and were represented to be broad regulatory compliance audits of UES's loan servicing operation. The compliance audits of UES were required to comply with the requirements of 34 C.F.R. § 682.802. CSLFC received copies of these audits on an annual basis, including the comforting audit report on UES issued by Peat Marwick in May 1988. These audits failed to disclose any material due diligence violations and repeatedly assured CSLFC that UES was in substantial compliance with all "Due Diligence" regulations.

Peat Marwick also provided other services related to UES for CSLFC. The auditors were engaged to provide complete audits of CSLFC's financial statements on an annual basis. As part of its audits of CSLFC, Peat Marwick concluded, based on its field work at CSLFC's servicers (including UES), that no reserve for uncollectible student loans was required.

Peat Marwick also served as the auditors of UES's annual financial statements, copies of which were furnished to CSLFC as required by CSLFC's servicing agreement with UES. Those audits also failed to disclose any material due diligence failures by UES.

In addition to auditing both UES and CSLFC, Peat Marwick provided extensive consulting services to CSLFC in 1987-88 relating to UES's internal controls, computer system, and regulatory compliance.

CSLFC relied upon its independent auditors to perform a complete audit of UES's servicing operations in connection with their auditing work for both CSLFC and UES and in connection with their consulting engagements for CSLFC. Peat Marwick failed to discover or disclose any material due diligence violations by UES. The current lawsuits against Peat Marwick may reveal why and how that could happen.

5. Question:

Numerous former UES employees have informed us that UES was informed ahead of time of the particular student files which were to be reviewed during the course of an audit. In light of this, what steps did CSLFC, or its auditors, take to ensure that those files had not been altered or otherwise tampered with for the purpose of these audits?

Answer:

CSLFC did not participate in Peat Marwick's review of UES files. Peat Marwick, as independent auditors, decided how many and what files to review, how to review them, and what procedures to use to insure that UES was in compliance with "due diligence" requirements. I do not know what steps, if any, Peat Marwick took to ensure that those files had not been altered or otherwise tampered with for the purpose of these audits.

6. Question:

What relationship or agreement was there between Rich Loritsch and CSLFC? During 1987, Mr. Loritsch had worked as a consultant at UES. What relationship or agreement was there between Loritsch and CSLFC at that time? Prior to coming to work for UES, Mr. Loritsch had worked with you at The Bank of America, had he not?

Answer:

CSLFC has never had a business relationship or business agreement with Rich Loritsch. In 1981 I worked with Mr. Loritsch at the Bank of America Student Loan Service Center. Shortly thereafter, Mr. Loritsch left to pursue a career in the consulting field and I came to work for CSLFC.

Mr. Loritsch and I had little or no contact until the end of 1986 when he telephoned me and indicated he had his own consulting business. Recognizing Mr. Loritsch's managerial expertise, I urged UES to hire him to review their operations and to ensure that UES could handle the growing volume of loans serviced.

7. Question:

A number of UES employees said that they considered Mr. Loritsch a spy for CSLFC. Did Mr. Loritsch provide you or anyone else at CSLFC with information on UES's operations? If so, what did you learn?

Answer:

I had hoped that Mr. Loritsch would keep CSLFC informed about servicing of CSLFC's loans, not as a spy, but rather in accordance with UES's contractual and fiduciary obligations. Commencing at approximately December 1987, Mr. Loritsch informed me about some back-logs and other problems, but he assured me, as did other UES personnel, that the problems had either already been solved or were in the process of being resolved.

8. Question:

CSLFC raised over $2 billion in bond sales, yet only $1.4 billion student loans are held by CSLFC. Where is the rest of the money?

Answer:

A number of bond issues were refunded, i.e., new bonds issued the proceeds of which were utilized to pay off and retire outstanding bonds. The retired debt issues are included in the $2 billion figure posed by the question. Furthermore, many of the indentures still have cash reserves established when the indentures were originally formed. In addition, CSLFC holds significant amounts of cash in the indentures, some of which represents unspent proceeds of original issuances of obligations and some of which represents repayments of principal received in respect of student loans.

9. Question:

In your testimony you stated that CSLFC, in order to receive special allowance payments from the Department of Education, was prohibited from discriminating in the purchase of its loans based upon, among other things, attendance by a student at a particular eligible institution. Can you cite this regulation? Based on your statement, does Sallie Mae (Student Loan Marketing Association) discriminate in its purchasing of student loans?

Answer:

As discussed in the answer to Question #2 above, the prohibition from discrimination referred to in the above question is contained in the statute, Section 438(d)(3) of the Higher Education Act, which provides:

> (3) NONDISCRIMINATION.-- In order for the holders of loans which were made or purchased with funds obtained by the holder from an Authority issuing obligations, the income

> from which is exempt from taxation under the Internal Revenue Code of 1954, to be eligible to receive a special allowance under subsection (b)(2) of this section on any such loans, the Authority shall not engage in any pattern or practice which results in a denial of a borrower's access to loans under this part because of the borrower's race, sex, color, religion, national origin, age, handicapped status, income, attendance at a particular eligible institution within the area served by the Authority, length of the borrower's educational program, or the borrower's academic year in school. [emphasis added]

Sallie Mae, so far as I know, is not prohibited by law from discriminating in the purchase of loans based upon the attendance by a student at a particular eligible institution. I am not aware of its present business practices. However, CSLFC has been advised by numerous lenders that prior to CSLFC's entry into the student loan secondary market Sallie Mae would restrict or refuse to purchase loans to students attending vocational and proprietary schools. One of the reasons that CSLFC was founded was to provide broader access to classes of students who were underserved as a result of Sallie Mae's restrictive policies.

RESPONSES TO FOLLOW-UP QUESTIONS

GRETCHEN STAFF
Former Vice President, Loan Servicing
United Education and Software

Question: Did you keep Mr. Cohen informed of problems of UES as you learned of them? What sorts of problems did you inform Mr. Cohen of over the years? Can you recount any specific instances when you informed him of problems?

> Answer: A monthly operations report was forwarded to Mr. Cohen updating him on the status of the Loan Servicing Center. The first section of the status report was a thumbnail sketch regarding the growth from the previous month including percentage increase in five areas: mail received, number of loans, number borrowers, incoming money received and total portfolio dollar value.
>
> Mr. Cohen was advised of problems ranging from personnel requirements, keeping pace problems, need for new equipment to improve prodoctivity, CSLFC's swap activity and impact on operations, system problems that I had inherited, variety of CSLFC's PR type situations both to CFLFC and their clients.
>
> A specific instance of discussion occurred approximately January, 1986. I was uneasy with the trend I was seeing at the Center in terms of large volumes of activity and the continuing new loans coming in each month. I expressed to CSLFC and to Mr. Cohen that I was researching consulting groups to assist the center in evaluating where we currently were, how to plan to for continuing growth, and to upgrade general management skills of myself and other personnel.
>
> On several occasions I asked Mr. Cohen if Mr. Jes Rifkind, a consultant, could spend some time with me and the Center. I conveyed to Mr. Cohen that it would be beneficial. Mr. Cohen replied it wasn't necessary and that I was "doing just fine."

Question: Did you ever have any conversations with anyone at CSLFC about slowing down the volume of loans being sent to UES for servicing? When did you have these conversations, with whom, and what was the result?

> **Answer**: I did discuss with CSLFC slowing the frequency of new loans. We needed to catch our breath. Agenda items were not being completed. We were generally in the middle of some new software release and needed to get it properly tested and incorporated into daily operations cycles. Frequent new loans were a major drain on not only the Review department but our DP systems and personnel. Conversations occurred with Mr. Cohen and with Mr. Nebeker. Mr. Nebeker's response was that while he empathized with our predicament, CSLFC would continue to have funds available whenever a Lender needed liquidity. Further, CSLFC expected UES to accommodate CSLFC. End result was no change.

Question: Did you ever ask anyone of CSLFC not to purchase certain loans for any reason? What were your reasons for asking that these loans not be purchased? What were you told in response to this request?

> **Answer**: Yes, there was a specific loan sale from Wells Fargo that involved loans previously rejected from CSAC for sundry reasons. Wells Fargo did obtain dispensation on those loans with new requirements for curing the loans. Upon conferring with our staff, we determined it would require more effort thatn UES could divert form other activity to perform the activities required to make those loans whole again.
>
> CSLFC expected to enhance their relationship with Wells Fargo by relieving them of this specific difficult group of loans. In addition CSLFC was vying with a competitor for a large portfolio of "prime" loans (loans from four year colleges/universities). This weighted the decision to take the difficult loans to win the "prime" loans.

Question: How would you describe the overall quality of the loans purchased by CSLFC for servicing by UES? How did this affect the ability of UES to properly service these loans?

> **Answer**: The quality of the loans generally was a condition of the status of a loan at the time of the sale and the Lender. If we were getting a loan in Enrolled or Grace status, the loan would be more likely to be up-to-date and with less chance for missing documents. In addition, loans and their accompanying physical file documentation, in the early years, 1984, 1985 and up[to mid 1986 appeared to be in better order and more correct.

Loans in Repayment were more difficult to review, transfer onto the system and subsequently service due to the probability of error in documentation or missing documentation. Furthermore the chances of missed payments between the Borrower, the original Lender and the new servicer was a concern.

There were new loans coming in that were canceling as soon as they were sold to CSLFC or in many cases were canceled at the time of the sale. Manifesting in either direction was a problem; corresponding with new loan Borrowers and applying refunds was difficult and time consuming. Documents, refunds and payments form lenders were slow in being forwarded to UES and often had "sat around" at a Lender's office prior to forwarding to UES.

Major problems revolved around documents forwarded from an original Lender:

Improper or insufficient information to match documentation or correspondence to Borrowers on the system.

Possible missed due diligency cycles due to delayed receipt of documentation or correspondence.

Missed deadlines for claims filings in bankruptcies and death.

I have the impression that once a Borrower's loan was sold to a Secondary Market, the original Lender's sense of timing urgencies diminishes.

Question: In 1983, UES was servicing approximately two million dollars worth of student loans. Just five years later, it was servicing $1.2 billion worth of student loans. Could you describe how this phenomenal growth occurred, and what effects this growth had on UES's ability properly to service all the accounts for which it was responsible?

Answer: CSLFC took an aggressive approach to acquiring a large portfolio. They obtained multiple bond issues to ensure availability of funds. They structured unique bond issues to purchase a variety of loans both within California and out-of-state loans. Their marketing efforts matched their financial inventiveness.

The complementary factor was a servicing arm that would unquestioningly be responsive and flexible to CSLFC and CSLFC's clients.

The growth of the two companies was an interdependency. UES's Loan Servicing Center was a young, enthusiastic organization that made every effort to be accurate in due diligence, to provide concerned customer service to Borrowers, to be innovative in every operational aspect and to overall provide quality, cost efficient service. The Center projected personalized attention.

I will always believe that our growth was due in large part to our being good at what we did. The growth however did get beyond our ability to properly service due to the sheer volume, the demands of CSLFC, systems that were unable to support the center, improper management levels and improper audit trails and controls.

Question: The Subcommittee's investigation has revealed a number of practices at UES which were, to say the least, highly questionable, and some of which were outright illegal. Among these practices of which the Subcommittee learned from numerous former UES employees were the falsification of due diligence records; the backdating of documents and mail; the submission of claims with the knowledge that due diligence had not been done; the use of drugs by employees; and the embezzlement of funds by at least one employee. You were in charge of UES's loan servicing operations for approximately five years; yet you told the Subcommittee staff that you were unaware of any of these activities at the time they were apparently taking place. Can you explain to the Subcommittee how you never heard a word about any of these activities when, apparently, numerous UES employees either had first-hand knowledge of them or had heard numerous rumors to that effect?

Answer: Regarding Falsification - To the best of my knowledge there was no falsification of records. There were instances where data was lost due to system problems and would have been reentered. There were instances where Borrowers' records were inadvertently "merged" on top of other borrowers' records and required recreating as separate records. There were instances where correct information was not entered at time of loan review and was subsequently added.

Backdating Documents & Mail - Backdating occurred when allowed by Due Diligence Regulations. There were also instances where records were updated (backdated) when it was discovered that documents had been in house all along or due to late receipt from an original Lender.

In few exceptions mail was generated within specified time frames.

Submitted Claims Lacked Due Diligence - I am not aware that the Center submitted claims that lacked Due Diligence.

Drug Use - I made every effort to ensure the Center was free of any substance abuse. We were the first UES division to require pre-employment physical exams. The primary objective to these exams was to prevent hiring persons that used drugs. Secondary certainly was obtaining baseline health information in the event of workers' compensation claims. Beyond that a free exam was a plus to prospective employees.

There was an instance of alcohol on the job. As always we worked closely with Human REsources. If anything we were "ham strung" due to employee protection laws. Unless an employer can prove on the job use or sale of substances or can prove impairment or endangerment little can be enforced.

Heresay, gossip or perception doesn't count. The use of substances on weekends was beyond an employer's scope. I can truthfully state there were only three names that ever came to my attention regarding substance use. One person went on extended medical leave, one person left the company shortly thereafter, I doubt the validity regarding the third person. There was one more person however I found out about it after they had been terminated and it related to prescribed medication. This person and family members were in therapy.

Embezzlement - I seriously doubt the truthfulness of the one instance that a subcommittee attorney related to me. I had a strong history of encouraging honesty, fairness and appropriate conduct. There were numerous occasions where I called general meetings on these subjects. The only problem we ever had regarding money involved personal money missing from employees. One time I had a Police Officer speak at a general meeting to confirm the Center's stance.

Question: I understand that UES performed what was known as "loan-swapping" for CSLFC. Would you explain what was involved in this "loan-swapping," how UES came to perform this service for CSLFC and what the reasons were for this "loan-swapping"? How, if at all, did this "loan-swapping" activity affect UES's regular servicing activities?

Answer: Swaps: The original objective of swaps was to "move" multiple loans of one Borrower from multiple portfolios into one portfolio in order to give the Borrower the lowest monthly payment available. Thus we would be able to service the Borrower better on several levels. This original concept was encouraged by CSAC and any Guarantor. This original concept held true for the first couple of swaps. However priorities changed as CSLFC began to initiate the swaps and their frequency increased.

Swaps are actually a very complicated, time consuming, time oriented process. Each portfolio involved must closely maintain the same dollar amount after the swap as prior to the swap. Each portfolio represents a specific bond issue with its own parameters for purchasing loans. Computer system activities should be closely monitored; there must be dollar amount and Borrower count verification. Those few times that the Center could drive swap activities, we felt more "comfortable" as we could better prepare. The number of swaps increased to its high in 1987 of approximately 24-26 swaps of various size. There were occasions where CSLFC advised us they made an error which resulted in our having to "unswap" Borrowers and dollars. There was never enough time to recover from a swap, perform normal activities or allow for new computer systems quality testing and proper incorporation into an operation before the next swap was announced.

The effects of the numerous swaps began to show in various areas and levels of difficulty:

Borrower coupons reflected incorrect portfolio identification which resulted in difficulty in applying payments.

Incorrect portfolio identification caused customer service problems including delayed responses to Borrower inquiries.

When a Borrower's loan was made in two disbursements, the loan looked like it was two individual loans on the system.

There were mirror images/duplicate portfolios sitting on the system to attempt to have an original "control" portfolio until a portfolio was completed by the Review department or until a swap was verified.

As a consequence of multiple portfolios of the same portfolio situation, the wrong portfolio (not the Live, working portfolio) could get updated i.e. delinquent mail, Deferment or Forbearance mail or payments/refunds applied.

At some point in late 1987 or the beginning of 1988 we became aware that due to swaps it was possible for a Borrower to miss a cycle. On numerous occasions we had advised CSLFC that swaps would have to occur with more control and in scheduled mode. At times CSLFC would agree to putting swaps "on hold". However invariably we would get a phone call advising a swap would have to take place.

Swap activity became a major factor in the Center's inability to properly manage the required activities in a student loan servicing environment or provide any focus for long range plans. In retrospect I see we were in a constant state of back paddling and turmoil.

Question: Would you describe for the Subcommittee the relationship between UES and CSLFC and how that relationship affected UES's servicing operations?

Answer: The Loan Servicing Center's relationship with CSLFC was the classic example of single customer dependency. As essentially our only customer, CSLFC expected the Center to meet every request; to be totally responsive and flexible for whatever opportunity CSLFC might take advantage of. The company expected me to see that the customer was satisfied.

When I would discuss with CSLFC any difficulty associated with their requests or timing considerations, I was oftened chided for expressing possible limitations and not displaying ready foresight and ability of the Center; of not being poised and prepared for whatever the next situation might be. It was often expressed that other servicers were always courting CSLFC. Responses to questions five and seven also relate to this question and the response.

Question: From 1986 to 1988, UES experienced an increase in the number of claims rejected by guarantee agencies,? Could you describe the progression of this increase? Did this increase in rejected claims ever raise any concerns in your mind or in anyone else's mind about potential problems with UES's due diligence activities?

Answer: It was not until approximately December, 1987 that I began to have an understanding of the number of rejected claims. I then informed Mr. Cohen that several areas were critical and would require substantial effort and dollars to stabilize. Mr. Cohen was advised that as my first supposition without details, that it would be into summer 1988 at a cost in the $1 million range to bring the Center back on an even keel.

The various departments began using daily inventory type sheets that would indicate current and previous day's holdover items. With the numbers from the daily sheets we were finally realizing how volatile the situations were. To further compound our difficulties the Center was at year end with its own set of priorities and critical activities.

This was December, 1987 and into January, 1988, yet at that time there still were critical items that were unknown to me and that I would not know until months after I was relieved of day-to-day responsibilities of the Center.

Question: I understand that in the late-1987, early-1988 time period, a daily log was kept at UES which included statistics on the number of accounts in repayment, the number of accounts claimed, and the number of accounts in cure status. You have admitted to the Subcommittee staff that at one time you participated in providing what was, in essence, a falsified version of the statistics on accounts in cure status to Richard Loritsch, who at the time was overseeing UES's servicing operations. What was the reason for providing Mr. Loritsch with inaccurate information on the number of accounts in cure status? Who was aware of, or participated in, this activity? Did you ever engage in any other falsifying of information at UES?

Answer: In mid March 1988 Rich Loritsch still as a consultant, assumed day-to-day responsibility for the Center except for all data processing/computer operations which was given to the UES South Dakota division. At least for the time we began using the daily sheets until I no longer had the Center, there were two sets of statistics on the number of accounts in cure status. I don't recall if there were two sets of stats on any other categories.

I believe Jeanne Rausch gave those to me. It was not a secret among our own personnel in that department. I made no secret that Mr. Loritsch had a different number for the cures. My impression was that UES personnel did not care for Mr. Loritsch. We were all biding our time until he would no longer be associated with the Center. We did not see any real value in his being at the Center. He was not trusted. We felt he had his own interest at heart rather than UES. It was not until Mr. Loritsch came to the Center that locks were installed on managers' doors. I had expressed my concerns regarding Mr. Loritsch on more than one occasion to Mr. Cohen and CSLFC.

Mr. Loritsch was given a separate set of cure numbers because it was close to the anticipated ending of his time at the Center. I did not want there to by any excuse for him to continue with the Center. As long as we tracked the correct cure number for ourselves and could plan using the correct number, I did not see any problem. I do not consider it a falsification.

I did not engage in falsifying information at UES.

Question: You have stated previously that during your last year-and-a-half with UES, you were often engaged in doing public relations work with Trent Nebeker of CSLFC. Why were you, as an employee of a servicing company, engaging in public relations work on behalf of a corporation which was attempting to operate a secondary market for the purchase of student loans?

Answer: CSLFC, a non profit organization, was like every other company with a marketing strategy and business goals. Like any other company it had competition. The same activities that any company would engage in occurred at CSLFC. In that same regard any company, UES, not withstanding, would participate in joint projects with its major customer. Perhaps more so in single customer dependency situations, are the customer's expectations high as well as the vendor scrambling to accommodate.

From the beginning (1984) my time had been splintered and diverted by:

- Accompanying CSLFC to client sites fore marketing and PR purposes.

  Analysis and design for a CLAS loan system including a two inch binder of documentation that was submitted to CSAC for comment and review.

  Multiple occasions where I was required to market the proposed CLAS loan system on my own including the required follow-up.

  Analyzing and responding in CSLFC's behalf to proposed REGs changes in early 1988.

  Considerable time assisting in analyzing CSLFC's strategy, presentation and marketing materials for Loan Consolidation.

  Considerable time designing a system to generated documents for use both for internal processing and those documents sent to prospective Loan Consolidation participants.

Generally I spent one day a week at CSLFC's office form September/October 1986 to December 1987.

Question: You have previously stated that you relied heavily on your operations manager, Leita Elliot, and that when you were not physically on site at UES, as you apparently were not during much of 1987, Ms. Elliot ran things. The Subcommittee staff was informed by numerous former UES employees, however, that it was Ms. Elliot who instructed them to take various questionable -- and, in some instances, improper -- steps with regard to the submission of claims to guarantee agencies. By 1988, the number of rejected claims was up to 20,000, and an audit by the Department of Education, the Higher Education Assistance Foundation, and the California Student Aid Commission had found that UES was totally unqualified to act as a servicer. In light of this, do you believe that Ms. Elliot hid from you the actual condition of UES's operations?

Answer: I don't see it as a matter of Ms. Elliott hiding conditions of the operation as much as she believing that the multitude of problems surfacing were still controllable. Moving into 1987 meant new software systems were being written, personnel were increasing at all levels in every department, a new organizational structure was planned along with recognition that our growth required more stringent controls and audit trails within the Center.

In late March 1987 we finally moved into adequate quarters after a year long search. I believe Ms. Elliott felt we could stay on an even keel until the many changes and plans were in place. Unfortunately the operation was already in a tenable position. Throughout 1987 there were too many factors that worked against us. There was always some new problem to overcome:

Unexpected and frequent swaps.

Software system schedules delayed.

Increasing number of loans to service each month.

Increased new loan applications to process.

New regulations; some with retro requirements.

Outgrew the hardware capability which slowed the response time and consequently the processing and productivity for all departments.

Question: Did UES ever have an internal audit unit for its loan-servicing operations? Were any attempts ever made to set up such a unit?

> Answer: In 1984 we had established a Quality Control person to monitor and investigate specific computer generated information on Borrower correspondence and system reports. When this person went on leave of absence the assignment was shared by several departments. The original person did not return. The position was not reactivated as a stand alone unit. Basically each department monitored its own activities and system related tasks. The only other internal audit unit was small unit (quality assurance) within computer operations established late 1987 for testing new programs. However plans for 1988 included a Compliance unit and a Quality Control unit.

STUDENT LOAN PORTFOLIOS 04-Sep-90

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 3

CONSERVATORSHIPS - AS OF 7/17/90, FIGURES AS OF 12/31/89

INSTITUTION	CITY	STATE	SIZE
CITY FS & LA	BIRMINGHAM	AL	$9,000
SAVERS SAVINGS ASSOC	LITTLE ROCK	AR	$1,779,000
FIRST SAVINGS OF ARKANSAS	LITTLE ROCK	AR	$5,368,000
COMMONWEALTH S & LA	OSCEOLA	AR	$11,000
MERCURY S & LA	HUNTINGTON BEACH	CA	$25,000
FOUNDERS FS&LA	LOS ANGELES	CA	$240,000
IMPERIAL SVGS	SAN DIEGO	CA	$13,787,000
SANTA BARBARA	SANTA BARBARA	CA	$45,000
CAPITOL FS & LA	AURORA	CO	$42,000
HERITAGE S&LA	LAMAR	CO	$398,000
FIRST AMERICAN, FSB	LONGMONT	CO	$100,000,000
MOULTRIE	MOULTRIE	GA	$91,000
FIRST FS & LA	WARNER ROBINS	GA	$3,169,000
BANC IOWA FED	CEDAR RAPIDS	IA	$186,000
GERMANIABANK	ALTON	IL	$1,000
ARLINGTON HEIGHTS SA	ARLINGTON HGHTS	IL	$935,000
FIDELITY FEDERAL SVGS	GALESBURG	IL	$1,129,000
GREAT AMERICAN	OAK PARK	IL	$43,000
SECURITY FS & LA	PEORIA	IL	$440,000
SUMMIT FIRST	SUMMIT	IL	$5,000
FIRST FS & LA	ANDERSON	IN	$140,000
HOMETOWN	DELPHI	IN	$12,000
VALLEY SAVINGS	HUTCHINSON	KS	$14,000
FIRST FSB	WELLINGTON	KS	$335,000
MID KANSA S & LA	WICHITA	KS	$16,000
CAPITAL-UNION	BATON ROUGE	LA	$3,000
FIRST FS & LA	BATON ROUGE	LA	$30,000
LOUISIANA SVGS ASSOC	LAKE CHARLES	LA	$665,000
FIRST FS & LA	NEW IBERIA	LA	$83,000
FIRST FS & LA	SHREVEPORT	LA	$531,000

Resolution Trust Corporation

HOME OWNERS SVGS	BOSTON	MA	$3,980,000
HOME FEDERAL SVGS	WORCESTER	MA	$168,000
MIDWEST SVGS ASSOC	MINNEAPOLIS	MN	$206,000
MISSISSIPPI SVGS	BATESVILLE	MS	$6,000
MIDWEST FED	MINOT	ND	$42,000
EQUITABLE	FREMONT	NE	$802,000
CITY SVGS BANK	ELIZABETH	NJ	$14,563,000
MUTUAL AID S&LA	MANASQUAN	NJ	$1,125,000
NORTH JERSEY	PASSAIC	NJ	$76,000
FIRST ATLANTIC S & LA	PLAINFIELD	NJ	$3,519,000
COLONIAL FED	ROSELLE PARK	NJ	$588,000
THE UNITED OF TRENTON	TRENTON	NJ	$205,000
SILVER SVGS ASSOC	SILVER CITY	NM	$148,000
NASSUA S & LA	BROOKLYN	NY	$5,000,000
SALAMANCA FED	SALAMANCA	NY	$62,000
MIDLAND-BUCKEYE SVGS	ALLIANCE	OH	$558,000
FREEDOM SAVINGS	COLUMBUS	OH	$57,000
FIRST S & I CO	MASSILLON	OH	$575,000
CIVIC SAVGS	PORTSMOUTH	OH	$10,000
CONTINENTAL FS & LA	OKLAHOMA CITY	OK	$12,116,000
GREAT PLAINS	WEATHERFORD	OK	$36,000
THE BEN FRANKLIN FS & LA	PORTLAND	OR	$8,000
CAGUAS-CENTRAL FED	CAGUAS	PR	$6,669,000
WINDSOR SVGS ASSOC	AUSTIN	TX	$1,305,000
TEXASBANC	CONROE	TX	$12,000
FORTUNE FINANCIAL	COPPERAS COVE	TX	$9,000
SOUTHWEST SA	DALLAS	TX	$3,000
SURETY FED	EL PASO	TX	$3,847,000
AMERICAN S & LA OF BRAZORIA	LAKE JACKSON	TX	$1,000
FIRST FS & LA	NEW BRAUNFELS	TX	$1,145,000
SECURITY FED	TEXARKANA	TX	$16,000
CENTRAL TEXAS S & LA	WACO	TX	$5,000
NORTH TEXAS FS & LA	WICHITA FALLS	TX	$94,000
SUB TOTAL		60	$186,488,000

RECEIVERSHIPS – AS OF 7/17/90, FIGURES AS OF 7/17/90

INSTITUTION	CITY	STATE	SIZE
BRICKELL BANC	MIAMI	FL	$23,000
FIRST FED	COFFEYVILLE	KS	$2,000
PEOPLES HERITAGE	SALINA	KS	$178,000
ELMWOOD	HARAHAN	LA	$25,000
FIRST FSLA OF SOUTHEAST, MO	CAPE GIRARDEAU	MO	$868,000
BLUE VALLEY	KANSAS CITY	MO	$41,000
NILE VALLEY	NEBRASKA CITY	NE	$4,000
VILLAGE	HOUSTON	TX	$707,000
TAYLOR	TAYLOR	TX	$3,626,000
DURAND	DURAND	WI	$85,000
COMMUNITY	FOND DU LAC	WI	$2,000
SUB TOTAL	11		$5,561,000
TOTAL	71		$192,049,000

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE INSPECTOR GENERAL

February 14, 1990

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 4

Management Improvement Report No. 90-9

TO : Dr. Leonard L. Haynes III
Assistant Secretary
Office of Postsecondary Education

FROM : Mitchell L. Laine Mitchell L. Laine
Assistant Inspector General for Audit

SUBJECT: Extensive Non-compliance by Certain Lenders with the Department of Education's (ED's) Guaranteed Student Loan Program Due Diligence Requirements

The purpose of this memorandum is to alert you to (1) the serious and continuing noncompliance by certain lenders with ED's due diligence requirements as identified in guarantee agencies' lender review reports, and (2) the need for improvements in the guarantee agencies' reported information.

Due diligence covers all areas of the loan process, including the making, disbursing, servicing, and collecting of guaranteed student loans. In November 1986, ED issued regulations which included revised due diligence and timely filing enforcement policies. The requirements set forth in these regulations are the minimum level of effort that lenders must undertake in collecting loans in order for agensies to qualify for reinsurance payments. These changes were made because the Secretary was alarmed at the rising costs of defaults in recent years. The revised regulations contained more stringent and specific due diligence and timely filing requirements for lenders.

Starting in December 1986, 34 CFR 682.410 (c) required guarantee agencies to do on-site reviews of certain lenders. Guarantee agencies must review lenders whose loan volume equals or exceeds 2 percent of the annual loan volume of the agency or the ten largest lenders based on loan volume for the year. According to the Spring 1989 revised lender review guide provided by ED, these reviews are to be thorough, including testing the lenders' compliance with ED's due diligence requirements. Upon completion of the reviews, the guarantee agencies send copies of their lender review reports to the Office of Student Financial Assistance's (OSFA) Division of Audit and Program Review (DAPR).

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Our Analysis of 101 Lender Reports Shows Extensive Due Diligence Exceptions at Certain Lenders

To determine whether lenders were meeting the due diligence requirements, we compiled the results reported by selected guarantee agencies on their lender review program. In addition, we assessed how ED used these reviews and findings to improve the overall SFA program. We analyzed 101 lender reviews performed during 1987 and 1988 by 13 guarantee agencies. The reviews covered lenders with about 1.8 million borrowers with outstanding loans of more than $5 billion. Of the 1.8 million borrowers, the lender reviewers examined 33,127 files.

Of the files examined, 28,977 (87 percent) contained what we considered to be due diligence exceptions. Over 18,000 of those exceptions were at one lender where the review noted that there were 18,153 delinquent accounts and that the lender had been unable to maintain consistency in follow-up efforts in contacting borrowers. The remaining 10,800 files (33 percent of the total) contained problems in all the due diligence areas. The lender reviews also identified problems in the areas of (1) billing and reporting interest and special allowance, (2) control and security within the lenders' EDP systems, and (3) maintenance of the GSL files.

Although there were exceptions in 10 different areas, 84 percent of the deficiencies were in three areas: (1) repayment and collection (80 percent); (2) system control, security, and file maintenance (2 percent); and (3) deferments (2 percent). Because of the relationship to borrowers' defaults, we consider repayment and collections to be a very significant phase in the guaranteed loan process for potential dollar impact on ED.

Reported Information Could Be Improved

The most frequently cited reasons for noncompliance (in those reports that cited the reason) were the lack of adequate electronic data processing (EDP) control systems and the lack of adequately trained personnel at the lenders to monitor and track the loan portfolios. However, the reports generally did not cite the reasons for errors or noncompliance with due diligence procedures. In addition, the reports did not always assign a dollar value to the noncompliance or say whether the lender made a financial adjustment for the exceptions. Also, in many instances a lender is in the top 10 lender group for more than one guarantee agency, and therefore will be reviewed by two or more guarantee agencies. In our analysis, two or more guarantee agencies reviewed six of the larger lenders, and most of the time, the guarantee agencies reviewed the lender in the same year. However, the lender review reports varied greatly between guarantee agencies in the level of testing and reported exceptions.

DAPR's Lender Review Branch regional office in Washington, D. C., performs a quality review of each lender report to determine whether (1) the site review guide was used, (2) the scope of the review was sufficient for a compliance review, and (3) the findings and related recommendations were appropriate. If the quality review shows significant problems with the report, DAPR sends a letter to the guarantee agency describing the problem and requesting further action. As of January 30, 1990 only one such letter had been sent to a guarantee agency, although others were pending.

Program officials acknowledge there are problems with the guarantee agencies' lender reports in the area of financial adjustments. However, they believe that the quality reviews and subsequent reports to the agencies is the best way to encourage the agencies to rethink their relationship with the lenders.

Lender Review Reports Could Be Used More Effectively

In addition to quality reviews of guarantee agency reports, the DAPR Washington regional staff perform lender reviews within their assigned geographic area. In fact, their primary responsibility is to perform lender reviews. This responsibility is shared with other regional Lender Review Branch offices.

Information from these OSFA lender reviews is captured in ED's Institutional Data System (IDS). However, for the guarantee agencies' lender reports, only the issue dates of the reports, and not the guarantee agencies' findings, are entered into the IDS. DAPR officials believe that their compliance reviews provide a better insight into problems at lenders.

DAPR's lender reviews may provide a better insight into lender problems than the guarantee agencies' reviews. However, the guarantee agencies' lender reviews still provide useful information about lender problems. If the two sources of information were captured, merged, and analyzed, the resulting data would be more useful than the OSFA data alone.

The review steps performed by DAPR staff are similar to those contained in the Lender Site Review Guide used by the guarantee agencies. Therefore, we believe that the findings reported by DAPR contain the same types of exceptions, but with greater liability assessments, as those reported by guarantee agencies. To illustrate, DAPR performed 298 lender reviews as of June 1989 and assessed $8.1 million in liabilities. During this same period guarantee agencies completed 364 lender reviews, but statistics were not available for the amount of liabilities assessed.

OSFA had not done trend analysis of the findings or captured the information contained in the guarantee agencies' lender reports. If the guarantee agencies' lender review findings were input into the IDS along with complete data from OSFA's lender reviews, OSFA could do comparative and trend analysis on the data which would aid OSFA in its process of selecting areas and lenders for review.

Corrective Actions are Needed

Although the revised due diligence regulations have been in effect for 3 years, lender reviews show a high level of noncompliance. The total Stafford loan volume for fiscal year 1988 was 4.5 million loans, representing about $11.8 billion in loan commitments. Because of the high rate of exceptions noted in our analysis, 87 percent (33 percent if the exceptions at the single largest lender are excluded), we believe ED should use stronger measures to ensure that lenders improve the management of their loan portfolios. Since the agencies' lender review reports that did identify reasons for noncompliance cited problems with EDP controls and lack of adequately trained personnel, we believe that immediate improvements in these areas are essential.

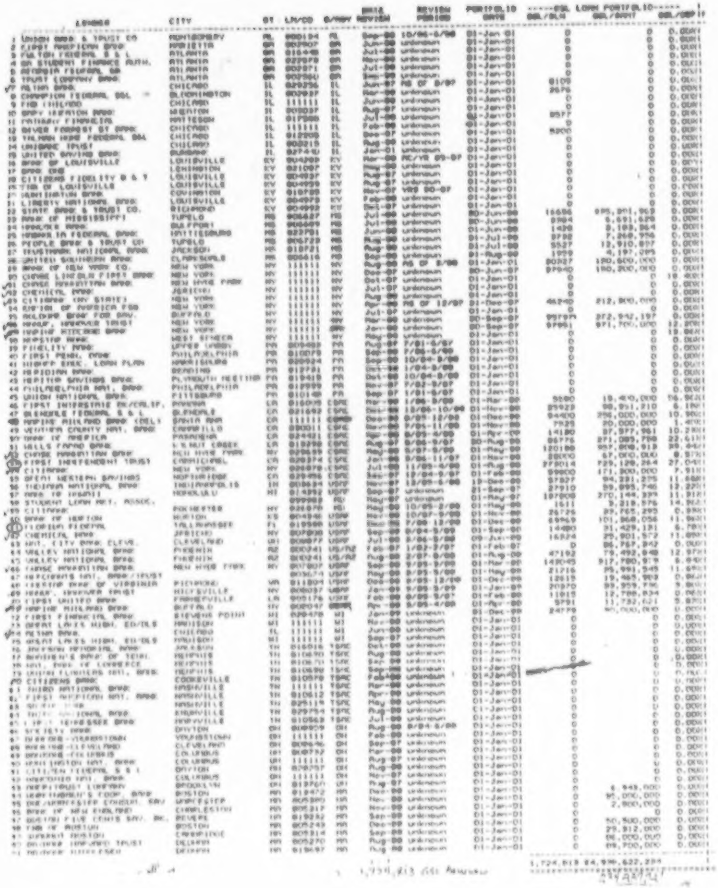
Recommendations

We recommend that ED (1) take immediate action, perhaps through a "Dear Colleague" letter, to communicate to all guarantee agencies and lenders the problems with EDP controls and lack of adequately trained staffs, and (2) require guarantee agencies and lenders to take immediate steps to address these problems.

We also recommend that OSFA (1) require guarantee agencies to improve their lender review reports by identifying the cause and the dollar impact of due diligence exceptions, and (2) improve its own capability to use these reports for monitoring the status of due diligence compliance by developing a method of analyzing data contained in the guarantee agencies' reports, and comparing that data with ED's own reports.

Program officials have indicated to us that, in dealing with the issues noted in this report, they will also have to consider any changes that may occur to individual programs as a result of the current reauthorization process.

We would appreciate your review and comments concerning our recommendations within 30 days of the above date. If you have any questions or would like to discuss our recommendations, please contact Carol Lynch, Chief, Postsecondary Education Audit Branch, on 732-5848.



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Senate Permanent Subcommittee
on Investigations

EXHIBIT # 6

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE INSPECTOR GENERAL

February 14, 1990

Management Improvement Report No. 90-6

TO : Dr. Leonard L. Haynes III
Assistant Secretary
Office of Postsecondary Education

Mitchell L. Laine

FROM : Mitchell L. Laine
Assistant Inspector General for Audit

SUBJECT: Improving the Department's Oversight of Secondary Markets

The purpose of this memorandum is to advise of the need to consider establishing a system of oversight of all secondary markets participating in the guaranteed student loan programs. Greater oversight will improve the Department's coverage of a large percentage of the student loans guaranteed by the Department.

Secondary markets are allowed to purchase student loans from lenders to ensure that sufficient funds are available for the guaranteed student loan programs. With this available liquidity, lenders can provide additional funds to student borrowers.

The largest student loan holder is the Student Loan Marketing Association (Sallie Mae), which was created by Congress to serve as a secondary market and warehousing facility for student loans. As of September 30, 1988, Sallie Mae held about $11.3 billion in student loans or about 25 percent of all outstanding loans. The top 100 loan holders, including Sallie Mae, controlled $32.5 billion (or 72 percent) of the outstanding guaranteed student loans.

In addition to Sallie Mae, we identified 48 secondary markets. (See Exhibit I.) As of September 30, 1988, 46 of these secondary markets held $6.9 billion in outstanding loans, or about 15 percent of all loans. Two organizations, with holdings of $174 million, used tax-exempt funding only;

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12, with holdings of $999 million, used taxable or State funding only; and the remaining 32 secondary markets, with holdings of $5 billion, used a combination of tax-exempt and taxable/State financing.

The laws and regulations do not specifically define what constitutes a secondary market. This may account for the fact that lenders which also purchase guaranteed student loans are not always identified as secondary markets. However, by accessing the fiscal year 1988 call reports, we will be able to determine which lenders purchased loans during the year ending September 30, 1988. This analysis is in process and will be forthcoming within a short time.

Oversight of Secondary Markets

Despite the overwhelming presence of secondary markets in the guaranteed student loan program, the U.S. Department of Education (ED) presently does not systematically receive and/or provide audit and/or program review coverage of these organizations. Our review also indicates that ED does not know how many secondary markets exist or whether anyone is evaluating their performance.

Not all secondary markets must submit audits to ED. Sallie Mae, which held over $11.3 billion in guaranteed student loans as of September 30, 1988, does not have to report to ED, but does report to Treasury and Congress. Lenders acting as secondary markets and Authorities using taxable or State financing to purchase loans have no legal requirement to submit audits to ED.

Federal laws and regulations prescribe audit requirements for Authorities using tax-exempt financing. Many of these are secondary markets. These authorities are required to submit a plan for doing business (Plan). The Higher Education Act (HEA) of 1965, as amended, Section 438(d)(2)(F) stipulates that:

> "there will be an annual audit of the Authority by a certified public accounting firm which will include review of compliance by the Authority with the provisions of the plan."

The same requirement is found in the guaranteed student loan regulations in 34 CFR Section 682.830 - Audit Standards. In addition, the standards require a financial and compliance audit of the Authority's loan and/or loan purchasing program. Further, the regulations stipulate that the Authority must submit a copy of the audit to ED's Regional Inspectors General. The legal and regulatory requirements have been in place since at least 1985.

Although the requirement seems specific enough, our review has disclosed that Authorities' compliance has been sporadic. Inquiries made to the Regional Inspectors General for Audit disclosed that only 13 of the 34 Authorities/secondary markets using tax-exempt financing submitted an audit report. Some of the reports were financial in nature; others covered financial and compliance aspects. A few entities were included as part of a Single Audit (A-128). Compliance testing of those entities can not be determined without reviewing the supporting working papers.

Exhibit II lists the 48 secondary markets and the available information on audit coverage. Beside each entity's name are notations indicating whether ED's Office of Postsecondary Education (OPE) or our regional offices (OIG) had audits on hand. The period and type of the latest audit are then identified.

Sallie Mae is governed by the Higher Education Act (HEA) of 1965, as amended. Public Law 99-498, Section 439(j) states that:

> "The accounts of the Association shall be audited annually. [and]...A report of each such audit shall be furnished to the Secretary of the Treasury."

Since Sallie Mae held about 25 percent of all student loans outstanding as of September 30, 1988, ED should have some oversight to protect the interests of the students, taxpayers and the Department. At the least, Sallie Mae should have an annual audit of its administration of the guaranteed student loan program done in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, and in accordance with an audit guide prepared by ED. This audit should be submitted to and reviewed by the Department.

Lenders purchasing student loans currently have no requirement to report to ED on their activities even though they are acting as secondary markets. From information taken from the Fiscal Year ending September 30, 1988 call reports, we plan to estimate the number of lenders acting as secondary markets and determine the volume of loans they purchased from other lenders. As previously noted, this data is being accumulated and will be available shortly. ED should have some assurance that these lenders/secondary markets are complying with program and regulatory requirements.

In the past, statistics on lender purchases were only available from the annual call reports. Starting with the December 1989 quarterly interest and special allowance billing, ED will receive improved data concerning entities that purchase student loans. Specifically, Part V, Line 5

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requires the lenders to enter the "Principal of Loans Purchased." ED should use that information to more closely monitor the major guaranteed student loan program participants.

ED also has program review requirements. The Guaranty Agency Programs regulation, 34 CFR Section 682.410 is entitled "Fiscal, administrative, and enforcement requirements". In Section 682.410(c)(1), the regulations specify that the guarantee agency shall conduct comprehensive biennial on-site program reviews of each participating lender whose loan volume constitutes two percent or more of all guaranteed loans in that year or who is one of the top ten largest lenders. The HEA, as amended, defines, in Section 435(i), holder as "...an eligible lender who owns a loan."

In Section 435(d), eligible lender includes:

> "for purposes only of purchasing and holding loans made by other lenders under this part, the [Sallie Mae] or an agency of any State functioning as a secondary market;".

Thus, the laws and regulations could be interpreted to mean that guarantee agencies must include secondary markets as part of the universe subject to review. To assist the guarantee agencies, OPE's Office of Student Financial Assistance (OSFA) has developed a lender site review guide. Chapter Nine of the guide lists the recommended steps which the reviewers should perform at secondary markets.

As a test to determine whether program reviews are being conducted, we asked a Regional OSFA office for its list of current lenders, including secondary markets. As of July 1989, none of the secondary markets had been reviewed by the guarantee agencies, and only one had been reviewed by OSFA. OPE officials in Washington, D.C. indicated that they are targeting secondary markets for OSFA regional office reviews during the latter part of fiscal year 1990. However, it does not appear that guarantee agencies are being required to review secondary markets.

Conclusions

ED needs greater oversight of secondary markets. Current Federal laws and regulations provide that State Authorities using tax-exempt funding must have annual financial and compliance audits completed and sent to ED's Regional Inspectors General. However, most Authorities are not sending reports to ED; and the reports being sent are not always financial and compliance audits which cover the administration of the guaranteed student loan program.

Authorities using taxable or State financing are not required to submit audits to ED. Neither is Sallie Mae, the largest secondary market, nor lenders which purchase loans and participate in the guaranteed student loan program as secondary markets.

OPE is planning program reviews of secondary markets to begin in the latter half of fiscal year 1990. However, the State guarantee agencies are apparently not routinely reviewing secondary market operations.

Recommendations

We recommend that ED establish a system of oversight of all secondary markets participating in the guaranteed student loan programs. The following suggestions are made to aid in the establishment of a system:

-- To ensure that all appropriate entities are included in the universe, ED should have the definition of secondary market inserted in the governing legislation and regulations.

-- ED should clarify the law and/or regulations to ensure that secondary markets are appropriately considered by guarantee agencies in their review selection process.

-- ED should monitor Authorities using tax-exempt financing to assure their submission of required audits to the Regional Inspectors General.

-- ED should also become involved in program reviews of secondary markets.

We also recommend that ED initiate action to change the legislation governing secondary markets to provide for annual audits of the secondary market's administration of the guaranteed student loan programs. These audits would be required if audit coverage of the secondary market is not already required, or will be required, under A-128, A-110, or A-133. The audits should be performed by a CPA in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States, and an audit guide prepared by ED. This audit should be submitted to ED; and oversight agencies, such as ED and guarantee agencies, should have access to the audit working papers.

Similarly, ED should consider initiating action to change legislation and/or regulations to ensure that Sallie Mae and all lenders/secondary markets, that own loans over a certain threshold, be subject to similar audits of their administration of the guaranteed student loan programs.

Program officials have indicated to us that, in dealing with the issues noted in this report, they will also have to consider any changes that may occur to individual programs as a result of the current reauthorization process.

We would appreciate your review and comments concerning our recommendations within 30 days of the above date. If you have any questions or would like to discuss our recommendations, please contact Carol Lynch, Chief, Postsecondary Education Audit Branch on 732-5848.

EXHIBITS

[illegible]
EXHIBIT

SECONDARY MARKET	FULL RATE	HALF RATE	TOTAL
	<-------	LOANS OUTSTANDING AT 9/30/88	------->
1. Alabama Higher Education Loan Corporation	$0	$73,805,562	$73,805,5
2. Arizona Educational Loan Marketing Corporation	$1,393,274	$117,145,856	$118,539,1
4. Western Loan Marketing Association	$144,842,789	$0	$144,842,7
5. Arkansas Student Loan Authority	$4,000,846	$33,087,273	$37,088,1
6. California Student Loan Finance Corporation	$251,249,026	$464,979,048	$716,228,0
7. California Higher Education Loan Authority, Inc.	$115,996,802	$0	$115,996,8
8. Colorado Student Obligation Bond Authority	$7,868,928	$139,135,532	$147,004,4
9. Connecticut Student Loan Foundation (Susie Mae)	$42,381,802	$0	$42,381,8
10. Higher Education Loan Program of D.C.	$106,066,995	$0	$106,066,9
11. Student Loan Fund of Idaho Marketing Association, Inc.	$7,937,775	$16,897,707	$24,835,4
12. Illinois Designated Account Purchase Program	$22,864,661	$164,225,687	$187,090,3
13. Indiana Secondary Market for Education Loans, Inc.	$182,291,885	$132,532,434	$314,824,3
14. Iowa Student Loan Liquidity Corporation	$105,159,128	$69,004,383	$174,163,5
15. Higher Education Loan Program of Kansas, Inc.	$222,827,970	$0	$222,827,9
16. Kentucky Higher Education Student Loan Corporation	$26,410,823	$242,410,975	$268,821,7
17. Louisiana Public Facilities Authority	$43,244,54[illegible]	$0	$43,244,5
18. New England Loan Marketing Corporation	$298,064,50[illegible]	$256,855,98[illegible]	$554,92[illegible]
20. Mississippi Higher Education Assistance Corporation	$2,830,228	$86,787,920	$89,618,14
21. Missouri Higher Education Loan Authority	$19,722,87[illegible]	$98,280,6[illegible]	$118,003,4
22. Montana Higher Education Loan Authority	$0	$100,685,329	$100,685,3
23. Nebraska Higher Education Loan Programs, Inc.	$457,960,291	$151,195,216	$609,155,50
24. New Mexico Educational Assistance Foundation	$23,942,527	$90,529,728	$114,472,25
25. Industrial Commission of North Dakota	$40,004,221	$123,190,277	$163,194,[illegible]
26. Student Loan Funding Corporation	$22,831,836	$125,6[illegible]	$148,502,51
27. Pennsylvania Higher Education Assistance Agency	$42,651,92[illegible]	$1,228,058,04[illegible]	$1,270,709,9
28. Puerto Rico Student Loan Authority	$6,372,27[illegible]	$0	$6,372,27
29. Rhode Island Student Loan Authority	$114,882,947	$0	$114,882,94
30. South Dakota Student Loan Corporation	$47,707,571	$206,632,375	$254,339,94
31. Higher Education Loan Program of Tennessee	$104,822,474	$0	$104,822,47
32. Abeline Higher Education Authority, Inc.	$2,869,162	$23,820,116	$26,689,278
33. Brazos Higher Education Authority	$2,772,029	$37,420,341	$40,192,370
34. Brazos Student Finance Corporation	$99,257,410	$0	$99,257,410
35. Central Texas Higher Education Authority, Inc.	$6,550,630	$51,754,53[illegible]	$58,305,16[illegible]
36. Greater East Texas Higher Education Authority	$152,410	$38,642,077	$38,794,487
37. North Texas Higher Education Authority, Inc.	$24,414,369	$79,170,366	$103,584,735
38. Panhandle-Plains Higher Education Authority, Inc.	$509,190	$29,071,570	$29,580,760
39. South Texas Higher Education Authority, Inc.	$9,825,002	$65,996,692	$75,821,694
40. Texas Secondary Market Association	$18,063,922	$0	$18,063,922
41. West Texas Higher Education Authority, Inc.	$184,090	$64,127,292	$64,311,382
42. Utah State Board of Regents for Education	$26,731,147	$141,255,393	$167,986,540
43. Vermont Student Assistance Corporation	$7,406,479	$82,291,841	$89,698,320
44. Virginia Education Loan Authority	$183,017,984	$178,166,531	$361,184,515
45. Student Loan Finance Association	$1,099,854	$89,864,885	$90,964,739
46. Higher Education Loan Program of West Virginia, Inc.	$169,156	$0	$169,156
47. State of Wisconsin Higher Educational Aid Board	$15,101,975	$54,029,198	$69,131,173
48. Wyoming Student Loan Corporation	$2,207,661	$33,470,178	$35,677,839
	$2,086,691,479	$4,002,596,638	$6,089,288,117

NOTES: Full Rate Special Allowance = taxable or State funding
Half Rate Special Allowance = tax exempt funding

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EXHIBIT II PAGE 1

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
1. Alabama Higher Education Loan Corporation One Court Square, Suite 221 Montgomery, Alabama 36197 tel: (205) 269-2700	OPE AUDIT Yes	10/1/83 - 9/30/85	Financial & Compliance
	OIG AUDIT No		Financial - to be sent
2. Arizona Educational Loan Marketing Corporation Suite 421 2600 North Central Avenue Phoenix, Arizona 85004 tel: (602) 252-5793	OPE AUDIT Yes	10/1/82 - 9/30/84	Financial
	OIG AUDIT No		
3. Arizona Student Loan Finance Corporation 3900 East Camelback Road, Suite 507 North Phoenix, Arizona 85018 tel: (602) 955-0363	OPE AUDIT Yes	7/1/82 - 6/30/84	Financial
	OIG AUDIT No		
4. Western Loan Marketing Association Suite 507N 3900 East Camelback Road Phoenix, Arizona 85018 tel: (602) 955-0363	OPE AUDIT No		
	OIG AUDIT No		
5. Arkansas Student Loan Authority Suite 8300, Tower Building 4th and Center Streets Little Rock, Arkansas 72201 tel: (501) 371-2952	OPE AUDIT Yes	7/1/82 - 6/30/84	Financial & Compliance
	OIG AUDIT No		
6. California Student Loan Finance Corporation 9570 West Pico Boulevard, Suite 100 Los Angeles, California 90035 tel: (213) 271-1135	OPE AUDIT No		
	OIG AUDIT No		

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
7. California Higher Education Loan Authority, Inc. Suite 1250 300 Market Street San Francisco, California 94111 Tel: (415) 391-3131	OPE AUDIT No		
	OIG AUDIT No		
8. Colorado Student Obligation Bond Authority P.O. Box 211069 Denver, Colorado 80221 Tel: (303) 629-6437	OPE AUDIT Yes	10/1/86 - 9/30/87	Financial & Compliance
	OIG AUDIT Yes	10/1/87 - 9/30/88	Financial
9. Connecticut Student Loan Foundation (Susie Mae) 525 Brook Street Rocky Hill, Ct. 06067 Tel: (203) 257-4001	OPE AUDIT No		
	OIG AUDIT No		
10. Higher Education Loan Program of D.C. Suite 1000 1023 Fifteenth Street, N.W. Washington, D.C. 20005 Tel: (202) 289-4720	OPE AUDIT Yes	11/1/79 - 9/30/82	Financial
	OIG AUDIT No		
11. Student Loan Fund of Idaho Marketing Association, Inc. PO Box 3 Fruitland,ID 83619-0390 Tel: (208) 452-4058	OPE AUDIT Yes	1/1/84 - 12/31/85	Financial
	OIG AUDIT No		
12. Illinois Designated Account Purchase Program PO Box IDAPP, 102 Wilmont Road Deerfield, IL 60015 Tel: (312) 948-8620	OPE AUDIT Yes	7/1/82 - 6/30/84	Financial
	OIG AUDIT Yes	7/1/85 - 6/30/87	Part of Single audit

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EXHIBIT 11 PAGE 2

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
13. Indiana Secondary Market for Education Loans, Inc. Suite 1900 251 N. Illinois Street Indianapolis, Indiana 46204 Tel: (317) 237-2000	OPE AUDIT Yes OIG AUDIT No	7/1/83 - 6/30/85	Financial & Compliance
14. Iowa Student Loan Liquidity Corporation 500 Colony Building 507 Tenth Street Des Moines, IA 50309-2604 Tel: (515) 242-5626	OPE AUDIT Yes OIG AUDIT No	7/1/82 - 6/30/84	Financial & Compliance
15. Higher Education Loan Program of Kansas, Inc. Suite 600 6800 College Boulevard Overland Park, Kansas 66211 Tel: (913) 345-1300	OPE AUDIT No OIG AUDIT No		
16. Kentucky Higher Education Student Loan Corporation 1050 US 127 South Frankfort, Kentucky 40601 Tel: (502) 564-3438	OPE AUDIT Yes OIG AUDIT Yes	7/1/85 - 6/30/86 7/1/87 - 6/30/88	Financial & Compliance Part of State-wide Audit
17. Louisiana Public Facilities Authority Four United Plaza Suite 100 8555 United Plaza Boulevard Baton Rouge, La. 70809 Tel: (504) 927-5712	OPE AUDIT No OIG AUDIT No		
18. Maine Educational Loan Marketing Corporation (MELMAC) PO Box 549 Augusta, Maine 04330 Tel: (207) 623-2600	OPE AUDIT Yes OIG AUDIT No	1/1/86 - 12/31/87	Financial

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
19. New England Loan Marketing Corporation 25 Braintree Hill Park Braintree, Massachusetts 02184 tel: (617) 373-3399	OPE AUDIT Yes	8/1/81 - 12/31/82	Financial
	OIG AUDIT No		
20. Mississippi Higher Education Assistance Corporation P.O. Box 4799 1867 Crane Ridge Drive Jackson, Mississippi 39216 tel: (601) 981-9414	OPE AUDIT Yes	1/1/85 - 12/31/86	Financial & Compliance
	OIG AUDIT No		
21. Missouri Higher Education Loan Authority 1215 Fern Ridge Parkway, Suite 208 St. Louis, Missouri 63141 tel: (314) 469-0600	OPE AUDIT Yes	1/1/88 - 12/31/88	Financial
	OIG AUDIT No		
22. Montana Higher Education Loan Authority 33 South Last Chance Gulch Helena, Montana 59620 tel: (406) 444-6597	OPE AUDIT Yes	7/1/87 - 6/30/88	Financial
	OIG AUDIT No		
23. Nebraska Higher Education Loan Programs, Inc. Box 6535 Lincoln, Nebraska 68506 tel: (402) 489-6521	OPE AUDIT Yes	6/1/83 - 5/31/84	Financial
	OIG AUDIT No		
24. New Mexico Educational Assistance Foundation 3900 Osuna Road, N.E. PO Box 27020 Albuquerque, New Mexico 87125 tel: (505) 345-3371	OPE AUDIT Yes	7/1/87 - 6/30/88	Financial
	OIG AUDIT Yes	7/1/87 - 6/30/88	Financial & Compliance

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EXHIBIT 31 PAGE 5

SECONDARY MARKETS

ENTITY NAME AND ADDRESS	PERIOD OF AUDIT	NOTES
25. Industrial Commission of North Dakota State Capitol Bismarch, North Dakota 58505 tel: (701) 224-3722	OPE AUDIT Yes 7/1/81 - 6/30/83 OIG AUDIT No	Financial
26. Student Loan Funding Corporation 550 Mercantile Library Building 414 Walnut Street Cincinnati, Ohio 45202 tel: (513) 241-9004	OPE AUDIT Yes 1/1/84 - 12/31/85 OIG AUDIT No	Financial
27. Pennsylvania Higher Education Assistance Agency Towne House 660 Boas Street Harrisburg, PA 17102-1398 tel: (717) 257-2500	OPE AUDIT No OIG AUDIT Yes 7/1/87 - 6/30/88	Part of Single audit
28. Puerto Rico Student Loan Authority PO Box 42560 San Juan, PR 00940-2560 tel: (809) 722-1425	OPE AUDIT No OIG AUDIT No	
29. Rhode Island Student Loan Authority 560 Jefferson Blvd. Warwick, RI 02886 tel: (401) 277-2050	OPE AUDIT Yes 11/13/81 - 6/30/83 OIG AUDIT Yes 7/1/85 - 6/30/86	Financial Part of Single audit
30. South Dakota Student Loan Corporation 105 First Avenue, SW Aberdeen, SD 57401 tel: (605) 229-5910	OPE AUDIT Yes 7/1/86 - 6/30/88 OIG AUDIT Yes 10/1/86 - 9/30,88	Financial

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
31. Higher Education Loan Program of Tennessee Suite 1802 404 James Robertson Parkway Nashville, TN 37219 Tel: (615) 255-2470	DPE AUDIT No DIG AUDIT No		
32. Abeline Higher Education Authority, Inc. 809 E.N. 16th Abeline, Texas 79601 Tel: (915) 672-6172	DPE AUDIT Yes DIG AUDIT Yes	6/1/87 - 5/31/88 6/1/87 - 5/31/88	Financial & Compliance Financial & Compliance
33. Brazos Higher Education Authority PO Box 1308 Waco, Texas 76703-1308 Tel: (817) 753-0915	DPE AUDIT No DIG AUDIT No		
34. Brazos Student Finance Corporation	DPE AUDIT DIG AUDIT No		
35. Central Texas Higher Education Authority, Inc. PO Box 8500-117 San Marcos, Texas 78667-8500 Tel: (512) 396-2920	DPE AUDIT No DIG AUDIT Yes	 9/1/86 - 8/31/87	 Financial
36. Greater East Texas Higher Education Authority 424 Tarrow College Station, Texas 77840 Tel: (409) 846-4599	DPE AUDIT Yes DIG AUDIT Yes	9/1/84 - 8/31/86 9/1/87 - 8/31/88	Financial Financial & Compliance

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SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
37. North Texas Higher Education Authority, Inc. 301 East Abram, Suite 750 Arlington, Texas 76010-1196 Tel: (817) 265-9156	OPE AUDIT Yes	9/1/83 - 8/31/85	Financial & Compliance
	OIG AUDIT Yes	9/1/87 - 8/31/88	Financial & Compliance
38. Panhandle-Plains Higher Education Authority, Inc. P.O. Box 839 Canyon, Texas 79015 Tel: (806) 655-2821	OPE AUDIT No		
	OIG AUDIT No		
39. South Texas Higher Education Authority, Inc. 520 Pecan Street Mc Allen, Texas 78501 Tel: (512) [illegible]	OPE AUDIT Yes	12/1/83 - 11/30/84	Financial & Compliance
	OIG AUDIT No		
40. Texas Secondary Market Association 4501 [illegible] Building, Suite 308 Bedford, Texas 76022 Tel: (817) 540-7008	OPE AUDIT No		
	OIG AUDIT No		
41. West Texas Higher Education Authority, Inc. 9434 Viscount, Suite 210 El Paso, Texas 79925 Tel: (915) 595-3400	OPE AUDIT Yes	9/1/85 - 8/31/87	Financial & Compliance
	OIG AUDIT No		
42. Utah State Board of Regents for Education 807 East South Temple, Suite 204 Salt Lake City, Utah 84102 Tel: (801) 538-5211	OPE AUDIT Yes	7/1/86 - 6/30/88	Financial
	OIG AUDIT Yes	7/1/86 - 6/30/87	Part of State-wide audit

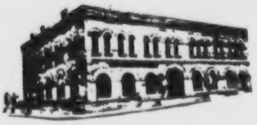
SECONDARY MARKETS

ENTITY NAME AND ADDRESS	PERIOD OF AUDIT	NOTES
43. Vermont Student Assistance Corporation Student Loan Marketing Program Champlain Mill PO Box 2000 Winooski, VT 05404 tel: (802) 655-9602	OPE AUDIT Yes 7/1/84 - 6/30/85	Financial
	OIG AUDIT No	
44. Virginia Education Loan Authority 737 North Fifth Street Richmond, Virginia 23219 tel: (804) 786-4025	OPE AUDIT Yes 7/1/83 - 6/30/84	Single Audit
	OIG AUDIT Yes 7/1/84 - 6/30/85	Single Audit
45. Student Loan Finance Association 500 Colman Building-Suite 11 811 First Avenue Seattle, Washington 98104 tel: (206) 625-1289	OPE AUDIT Yes 7/1/84 - 6/30/85	Financial & Compliance
	OIG AUDIT No	
46. Higher Education Loan Program of West Virginia, Inc. PO Box 591 Charleston, WV 25322 tel: (304) 345-7211	OPE AUDIT No	
	OIG AUDIT No	
47. State of Wisconsin Higher Educational Aid Board 25 West Main Street, Suite 800 Madison, Wisconsin 53707 tel: (608) 267-2206	OPE AUDIT Yes 7/1/82 - 6/30/84	Financial
	OIG AUDIT Yes 7/1/83 - 6/30/85	No compliance testing
47. State of Wisconsin Higher Educational Aid Board 25 West Main Street, Suite 800 Madison, Wisconsin 53707 tel: (608) 267-2206	OPE AUDIT	
	OIG AUDIT Yes 7/1/85 - 6/30/87	Part of Single Audit

SECONDARY MARKETS

ENTITY NAME AND ADDRESS		PERIOD OF AUDIT	NOTES
47. State of Wisconsin Higher Educational Aid Board 35 West Main Street, Suite 800 Madison, Wisconsin 53707 tel: (608) 267-2206	OPE AUDIT OIG AUDIT Yes	 7/1/87 - 6/30/88	 Part of Single audit
48. Wyoming Student Loan Corporation PO Box 3594 Cheyenne, Wyoming 82003 tel: (307) 635-[illegible]	OPE AUDIT Yes OIG AUDIT No	4/1/85 - 3/31/87	Financial

913/486-2124



THE BANK OF HORTON

HORTON, KANSAS
66439

VAN B. NORRIS
PRESIDENT

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 7

March 22, 1988

Mr. Saul Moskowitz
Department of Education
Guaranteed Student Loan Program
7th & "D" Street Southwest
Room 4310
G.S.A. Building
Washington, D.C. 20202

Dear Mr. Moskowitz,

Enclosed please find an original and one copy of the Limitation Agreement between the Department of Education and the Bank of Horton as faxed to the bank on Monday, and modified by phone conversation between yourself and our counsel, Mr. John Weingart, on Tuesday. We ask that the copy be signed by your office and returned to complete our files.

We would greatly appreciate your contacting us to confirm receipt of this agreement, and sincerely hope that our timely compliance in accepting this agreement would earn us your approval to commence our processing operations on Wednesday. We wish to minimize the service delays to our client schools as much as possible and hope our delivery of a signed agreement fulfills our responsibilities requisite to lift the moratorium on our operations.

Thank you for your speedy efforts in drafting this agreement, and the many kind considerations you and your staff showed us while we were in Washington. You have my pledge that we will make every effort to transmit the billings for interest benefits and special allowance, and origination fees owed by the bank as soon as possible. Thank you, too, for the added time you have allowed us in this matter.

Sincerely,

Van B. Norris

Van B. Norris
President

LIMITATION AGREEMENT

THIS LIMITATION AGREEMENT is entered into by the UNITED STATES DEPARTMENT OF EDUCATION ("ED") and THE BANK OF HORTON, Horton, Kansas, ("THE BANK") to resolve certain issues arising out of a lender review ("the review") conducted by ED of the BANK on October 20-23, 1987, as follows:

WHEREAS, ED found in the review and confirmed in later discussions with officials of the BANK that more than fifty (50) percent of the BANK's current consumer credit loan portfolio is comprised of loans made under the Guaranteed Student Loan (GSL), Supplemental Loans for Students (SLS), and PLUS programs;

WHEREAS, ED has determined that the BANK is thereby in violation of Sec. 435(d)(1)(A)(ii) of the Higher Education Act of 1965, as amended ("HEA") and 34 CFR Sec. 682.200 (definition of "lenders", paragraph (2)(ii)(B));

WHEREAS, the BANK disagrees with this determination based on HEA Sec. 435(d)(I)(A)(ii)(II);

WHEREAS, the BANK has assured the Secretary that it acted at all times under a good faith belief that it was in compliance with Sec. 435(d)(1)(A) and Sec. 682.200;

WHEREAS, ED has also found in the review that the BANK failed to submit billings to ED for interest benefits and special allowance for certain calendar quarters, resulting in the BANK's failure to pay origination fees to the Secretary on certain GSL, SLS, and PLUS program loans; and

WHEREAS, the parties wish to resolve this dispute without the expenses of litigation;

NOW, THEREFORE, the parties hereby agree as follows:

(1) Within 60 days of the date of ED's execution of this agreement, the BANK shall provide ED with a written certification from an independent certified public accountant, applying generally accepted accounting principles, stating that the bank has achieved compliance with ED's view of HEA Sec. 435(d)(1)(A) and 34 CFR Sec. 682.200 by increasing its consumer credit loan portfolio, exclusive of GSL, SLS, and PLUS program loans, by a dollar amount of loans sufficient to cause its GSL, SLS and PLUS program loans to constitute 50% or less of its consumer credit loan portfolio. Residential mortgages that the BANK is entitled by contract to service on behalf of the owners thereof as of such 60th day may be included in calculating the dollar amount of loans comprising the BANK's consumer credit loan portfolio.

(2) From the date of ED's execution of this agreement, through and including the date on which ED receives the certification described in paragraph (1), or through and including the 60th day following ED's execution of this agreement, whichever is earlier, the BANK may not disburse GSL, SLS, or PLUS program loans in excess of $30,000,000 in original principal.

(3) For one year following ED's receipt of the certification described in paragraph (1), the BANK shall submit to ED on at least a quarterly basis, written reports, certified by independent certified public accountants, applying generally accepted accounting principles, with respect to:

(a) the dollar amount of GSL, SLS, and PLUS program loans it holds; and

(b) the dollar amount of its entire consumer credit portfolio, including home mortgages owned or serviced by the BANK.

(4) If the BANK fails to provide the certification described in paragraph (1), within 60 days of ED's execution of this agreement, the BANK shall neither make nor purchase any GSL, SLS or PLUS program loans until such time thereafter as ED receives such certification described in paragraph (1) from the BANK.

(5) Not more than 30 days following the date of ED's execution of this agreement, the BANK shall transmit to ED:

(a) the six billings for interest benefits and special allowance, and

(b) all origination fees owed ED by the BANK, as requested by ED in paragraph two of the Lender Review Report sent to BANK by letter of March 7, 1988, from Lyndon Lee, Chief, Lender Review Branch, to Kevin Struckhoff, Vice-President, Bank of Horton. However, the BANK may deduct from this payment any interest benefits and special allowance that the BANK has not received and to which the BANK is entitled on the loans for which the origination fees are owed to ED. The payment may be made by cashier's check or by wire transfer, as determined by the BANK. The BANK shall provide ED, at or before the time of payment of the origination fees, and shall maintain as required by regulation, documentation supporting its calculation of the origination fees owed, and the interest benefits and special allowance deducted therefrom.

(6) In reliance on the above premises and assurances, and in consideration of the above undertakings, ED and the BANK hereby waive all rights, claims, and interests arising out of the BANK's alleged violation of Sec. 433(d)(1)(A) and Sec. 682.200

(definition of lender, paragraph (2) (ii)) prior to the date of ED's execution of this agreement, and arising out of its failure to submit billings for interest benefits and special allowance to the Secretary for the period covered by the lender review.

(7) This agreement constitutes the entire agreement between the parties.

(8) The individuals whose signatures appear below are fully authorised to execute this agreement on behalf of ED and the BANK.

3/24/88
Date

DEPARTMENT OF EDUCATION
By:

3/23/88
Date

BANK OF HORTON
By:

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 9-A

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of

BANK OF HORTON
HORTON, KANSAS

(INSURED STATE NONMEMBER BANK)

STIPULATION AND CONSENT
TO THE ISSUANCE OF AN
ORDER TO CEASE AND DESIST

FDIC-90-86b

Subject to the acceptance of this STIPULATION AND CONSENT TO THE ISSUANCE OF AN ORDER TO CEASE AND DESIST ("CONSENT AGREEMENT") by the Federal Deposit Insurance Corporation ("FDIC"), it is hereby stipulated and agreed by and between a representative of the Legal Division of the FDIC and Bank of Horton, Horton, Kansas ("Bank"), through its board of directors, as follows:

1. The Bank has been advised of its right to receive a Notice of Charges and of Hearing ("Notice") detailing the unsafe or unsound banking practices and violations of law and regulations alleged to have been committed by the Bank and of its right to a hearing on the alleged charges under section 8(b) of the Federal Deposit Insurance Act ("Act"), 12 U.S.C. § 1818 (b), and Part 308 of the FDIC's Rules of Practice and Procedures, 12 C.F.R. Part 308, and has waived those rights.

2. The Bank, solely for the purpose of this proceeding and without admitting or denying any of the alleged charges of unsafe or unsound banking practices and violations of law and regulations, hereby consents and agrees to the issuance of an ORDER TO CEASE AND DESIST ("ORDER") by the FDIC. The Bank further stipulates and agrees that such ORDER shall become effective ten (10) days after its issuance by the FDIC and shall be final and fully enforceable by the FDIC pursuant to the provisions of section 8(i) of the Act, 12 U.S.C. § 1818(i), subject only to the conditions set forth in paragraph 3 of this CONSENT AGREEMENT.

3. In the event that the FDIC accepts this CONSENT AGREEMENT and issues the ORDER, it is agreed that no action to enforce said ORDER in the United States District Court will be taken by the FDIC unless the FDIC determines the Bank or any Institution-Affiliated Party, its successor or assign has violated or is about to violate any provision of the ORDER.

4. The Bank hereby waives:

(a) The receipt of a Notice;

(b) All defenses to such alleged charges;

(c) A hearing for the purpose of taking evidence on such alleged charges;

(d) The filing of proposed findings of fact and conclusions of law;

(e) A recommended decision of an administrative law judge; and

(f) Exceptions and briefs with respect to such recommended decision.

Dated this 9th day of May , 1990.

FEDERAL DEPOSIT INSURANCE CORPORATION
LEGAL DIVISION

J. Michael Gillespie
Regional Attorney

BANK OF HORTON
HORTON, KANSAS

BY:
Pursuant to the Resolution of
the Board of Directors of
Bank of Horton
Horton, Kansas,
attached hereto.

Senate Permanent Subcommittee on Investigations

EXHIBIT # 9-B

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C.

In the Matter of BANK OF HORTON HORTON, KANSAS (INSURED STATE NONMEMBER BANK)	ORDER TO CEASE AND DESIST FDIC-90-86b

Bank of Horton, Horton, Kansas ("Bank"), having been advised of its right to a Notice of Charges and of Hearing detailing the unsafe or unsound banking practices and violations of law and/or regulations alleged to have been committed by the Bank and of its right to a hearing on such alleged charges under section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b), and having waived those rights, entered into a STIPULATION AND CONSENT TO THE ISSUANCE OF AN ORDER TO CEASE AND DESIST ("CONSENT AGREEMENT") with counsel for the Federal Deposit Insurance Corporation ("FDIC"), dated May 9, 1990, whereby solely for the purpose of this proceeding and without admitting or denying any unsafe or unsound banking practices or violations of law and/or regulations, the Bank consented to the issuance of an ORDER TO CEASE AND DESIST ("ORDER") by the FDIC.

The FDIC considered the matter and determined that it had reason to believe that the Bank had engaged in unsafe or unsound banking practices and had violated laws and/or regulations. The FDIC, therefore, accepted the CONSENT AGREEMENT and issued the following:

ORDER TO CEASE AND DESIST

IT IS HEREBY ORDERED, that the Bank, its Institution-Affiliated Parties, as that term is defined in section 3(u) of the Act, 12 U.S.C. § 1813(u), and its successors and assigns cease and desist from the following unsafe and unsound banking practices and violations of law and/or regulations:

A. operating with inadequate capital and allowance for loan and lease losses for the kind and quality of assets held;

B. engaging in violations of applicable laws and regulations;

C. operating with management whose policies and practices are detrimental to the Bank;

D. engaging in practices which produce inadequate operating income;

E. paying excessive cash dividends in relation to the Bank's net income and/or capital position;

F. operating with an inadequate allowance for loan and lease losses for the volume, kind and quality of loans held;

G. engaging in hazardous lending practices, including making student loans without adequate controls;

H. failing to provide adequate supervision, direction and planning over the affairs of the Bank to prevent unsafe or unsound practices and violations of law and/or regulations;

I. operating the Bank with management that has inadequate experience, qualifications, knowledge and training for the safe and sound operation of the Bank's student loan business;

J. excessively using brokered deposits to fund asset growth without adequate correlation between the maturity distribution of the brokered deposits and the assets, resulting in undue strain on the Bank's liquidity; and

K. engaging in asset growth without maintaining adequate capital to support such growth.

IT IS FURTHER ORDERED, that the Bank, its Institution-Affiliated Parties, and its successors and assigns, take affirmative action as follows:

1. For the purposes of this ORDER, the following terms have the meanings indicated:

(a) "Brokered Deposit(s)" has the same meaning as defined in section 337.6(a)(1) of FDIC's Rules and Regulations, 54 Fed. Reg. 51014 (Dec. 12, 1989), to be codified at 12 C.F.R. § 337.6(a)(1), as the same may be from time to time amended, replaced, or extended.

(b) "Extension of Credit" has the same meaning as defined in section 215.3 of Regulation O of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 215.3, except that it also includes a commitment to make an Extension of Credit.

(c) "Guarantee Agency" means a State or private nonprofit organization that has an agreement with the Secretary of the U.S. Department of Education to administer a loan guarantee program under the Higher Education Act of 1965, as amended, 20 U.S.C. § 1070 et seq. ("Higher Education Act of 1965");

(d) "Institution" means:

  (i) a public or private institution of higher education,

  (ii) a proprietary institution of higher education,

  (iii) a postsecondary vocational institution, or

  (iv) a vocational school.

(e) "Institutional Default Rate" has the same meaning as the term "fiscal year default rate" in section 668.15(f) of the U.S. Department of Education's Rules and Regulations, 34 C.F.R. § 668.15(f), as the same may be from time to time amended, replaced, or extended.

(f) "Student Loan" means an Extension of Credit, with or without a Federal government guarantee or reinsurance, to or for the benefit of a student, to enable the student to pay the costs of obtaining a postsecondary education, including, without limitation, an Extension of Credit authorized under Title IV of the Higher Education Act of 1965, and the following programs under Title IV:

(i) the Guaranteed Student Loan (Stafford Loan) Program, 20 U.S.C. § 1071 et seq.;

(ii) the Supplemental Loans for Students (SLS) Program, 20 U.S.C. § 1078-1;

(iii) the Parent Loans to Undergraduate Students (PLUS) Program, 20 U.S.C. § 1078-2;

(iv) the Consolidation Loan Program, 20 U.S.C. § 1078-3;

(v) the Income Contingent Loan Program, 20 U.S.C. § 1087aa et seq.; and

(vi) the Perkins Loan Program, 20 U.S.C. § 1087a et seq.

(g) "Student Loan Commitments" mean the aggregate amount of the Bank's commitments to advance funds in connection with Student Loans, including both initial and subsequent advances on Student Loans.

2. (a) (i) No more than 90 days from the effective date of this ORDER, the Bank shall have and thereafter retain qualified management. Such management shall include a qualified senior executive officer who shall be given stated written authority by the Bank's board of

directors to supervise the Bank's Student Loan business, including responsibility for implementing and maintaining lending and operating policies and practices in accord with sound banking practices. The senior executive officer shall have appropriate qualifications and experience to manage and supervise all aspects of the Bank's Student Loan business. Prior to the addition of any individual to the board of directors or the employment of any individual as a senior executive officer, the Bank shall comply with the requirements of section 32 of the Act, 12 U.S.C. § 1831i, and section 303.14 of the FDIC Rules and Regulations, 54 Fed. Reg. 53040 and 53043 (to be codified at 12 C.F.R. § 303.14).

(ii) The assessment of whether the Bank has "qualified management" shall be based upon management's conduct, both individual and joint, with respect to the Bank in: (A) complying with the requirements of this ORDER; (B) complying with applicable laws and regulations; and (C) not engaging in any unsafe or unsound banking practice which has an adverse effect on the Bank's asset quality, capital adequacy, earnings, or liquidity.

(b) The board of directors shall in no more than 30 days from the effective date of this ORDER develop a written analysis and assessment of the Bank's management and staffing needs ("management plan"), which shall include, at a minimum:

(i) identification of both the type and number of officer positions needed to manage and supervise properly the affairs of the Bank, including the Bank's Student Loan business;

(ii) identification and establishment of such Bank committees as are needed to provide guidance and oversight to active management;

(iii) evaluation of each Bank officer, and in particular the senior executive officer responsible for the Bank's Student Loan business, and staff member to determine whether these individuals possess the ability, experience and other qualifications required to perform present and anticipated duties, including adherence to the Bank's established policies and practices, and maintenance of the Bank in a safe and sound condition; and

(iv) a plan of action to recruit and hire any additional or replacement personnel with the requisite ability, experience and other qualifications, which the board of directors determines are necessary to fill Bank officer or staff member positions consistent with the board's analysis, evaluation and assessment as provided in paragraphs 1(b)(i) and 1(b)(iii) of this ORDER.

(c) The written management plan shall be submitted to the Regional Director for review and comment within 30 days after the effective date of this ORDER. No more than 30 days after the receipt of any comment from the Regional Director, and after consideration of such comment, the board of directors shall approve the written management plan and/or any modification thereto made upon consideration of any comment from the Regional Director, which approval shall be recorded in the minutes at the board of directors. Thereafter, the Bank and its Institution-Affiliated Parties shall implement and follow the written management plan. Any subsequent modification to the management plan shall be immediately submitted to the Regional Director for review and comment and shall be subject to the requirements of this paragraph 2(c).

(d) After the effective date of this ORDER, the Bank's board of directors shall meet at least monthly. The board shall prepare in advance and shall follow a detailed written agenda at each meeting, which shall include consideration of actions of any committees. Nothing in the foregoing sentence shall preclude the board from considering matters other than those contained in the agenda. Detailed written minutes of all board meetings shall be maintained and recorded on a timely basis.

3. (a) (i) No later than July 31, 1991, the Bank shall have total equity capital, exclusive of the allowance for loan and lease losses required to be maintained in accordance with paragraph 4 of this ORDER, at or in excess of 6 percent of the Bank's total assets ("equity capital ratio") and shall thereafter maintain its equity capital ratio at or in excess of such level as calculated herein while this ORDER is in effect. The terms "total equity capital" and "total assets" shall have the same meaning as those terms have in the prevailing Instructions for Preparation of Reports of Condition ("Instructions"), except "total assets" shall also include Student Loan Commitments.

(ii) Commencing July 31, 1991, the equity capital ratio shall be calculated as of each Report

Date, as that term is used in the Instructions. For the purpose of calculating the equity capital ratio as of a given Report Date:

(A) total equity capital shall be the amount of total equity capital required to be included in the Bank's Report of Condition;

(B) total assets shall be the average of total assets required to be included in the Schedule of quarterly averages of the Bank's Report of Condition, plus the average of the four month-end amounts of Student Loan Commitments computed as of the last day of the preceding quarter and as of the last day of each month of the currently-reported quarter;

(C) total equity capital and total assets reported in the Bank's Report of Condition shall be calculated in accordance with the prevailing Instructions;

(D) the Bank shall have an adequate allowance for loan and lease losses in accordance with paragraph 4 of this ORDER; and

(E) no later than the required filing date for each of the Bank's Reports of

Condition, the Bank shall separately report to the Regional Director the actual Student Loan Commitments for each month-end used to calculate total assets in paragraph 3(a)(ii)(B) above.

(b) (i) In order to achieve the equity capital ratio required by paragraph 3(a)(i), the Bank shall have an equity capital ratio, as of the dates listed in this paragraph 3(b)(i), at or in excess of the prescribed percentage:

Effective Date	Required Equity Capital Ratio
June 30, 1990	3.00%
July 31, 1990	3.15%
August 31, 1990	3.22%
September 30, 1990	3.38%
October 31, 1990	3.58%
November 30, 1990	3.68%
December 31, 1990	3.75%
January 31, 1991	3.75%
February 28, 1991	3.95%
March 31, 1991	4.50%
April 30, 1991	5.15%
May 31, 1991	5.40%
June 30, 1991	5.80%
July 31, 1991	6.00%

(ii) For the purpose of calculating the monthly equity capital ratios required by paragraph 3(b)(i), "equity capital ratio" shall mean the Bank's equity capital, exclusive of the allowance for loan and lease losses, divided by the Bank's total assets. In computing such equity capital ratio, the Bank's total assets shall be the average of the sum of the Bank's daily total assets for the month of calculation, plus Student Loan Commitments computed as of the last business day of the month of calculation.

(iii) In order to determine compliance with the monthly equity capital ratios required by paragraph 3(b)(i) of this ORDER, such equity capital ratios shall be computed as of the last business day of each calendar month.

(c) (i) Within 45 days after the effective date of this ORDER, the Bank shall develop a written plan to restore its equity capital ratio to 6 percent, which capital plan shall include, at a minimum:

(A) methods and strategies for restoring the Bank's equity capital ratio to 6 percent by July 31, 1991;

(B) methods and strategies for achieving specific target equity capital ratios for each calendar month during the term of the plan, which target equity capital ratios shall be at least equal to the equity capital ratios required by paragraph 3(b)(i); and

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(C) methods and strategies for reducing the total dollar amount of Student Loans held on the Bank's books more than 120 days as required by paragraph 6(a).

(ii) The written capital plan shall be submitted to the Regional Director for review and comment within 45 days after the effective date of this ORDER. No more than 30 days after the receipt of any comment from the Regional Director, and after consideration of such comment, the board of directors shall approve the written capital plan and/or any modification thereto made after consideration of any comment from the Regional Director. Thereafter, the Bank and its Institution-Affiliated Parties shall follow the written capital plan. Any subsequent modification to the capital plan shall be immediately submitted to the Regional Director for review and comment and shall be subject to the requirements of this paragraph 3(c)(ii) and paragraph 3(e).

(d) After July 31, 1991, if the equity capital ratio, exclusive of the allowance for loan and lease losses, declines below 6 percent, the Bank, within 30 days after the date on which the said ratio so declined, shall develop and implement a written plan to increase such ratio up to or in excess of 6 percent. No more than 60 days after the implementation of the written plan, the Bank's equity capital ratio, exclusive of the allowance for loan and lease losses, shall equal or exceed 6 percent and the Bank shall thereafter maintain its equity capital ratio at or in excess of such level as calculated herein while this ORDER is in effect.

(e) The Bank's board of directors shall maintain in its minutes a complete written record of all actions taken by the Bank to comply with the capital requirements of paragraphs 3(a) through 3(d) of this ORDER, including the board's deliberations with respect to any comment from the Regional Director regarding the Bank's written capital plan and the board's approval of the written capital plan.

(f) (i) If the Bank fails to achieve any of the monthly equity capital ratios required by paragraph 3(b)(i), the Bank shall immediately cease making, approving, or purchasing Student Loans and shall not, except with the prior written consent of the Regional Director, thereafter make, approve, or purchase, directly or indirectly, any Student Loan until such time as the Bank is in compliance with paragraph 3(b)(i) and provides evidence of such compliance satisfactory to the Regional Director.

(ii) If, at any time after July 31, 1991, the equity capital ratio required by paragraph 3(a) declines below 6 percent, the Bank shall immediately cease making, approving, or purchasing Student Loans, and shall not, except with the prior written consent of the Regional Director, thereafter make, approve, or purchase, directly or indirectly, any Student Loan until such time as the Bank's equity capital ratio is at least 6 percent and the Bank provides evidence of such fact satisfactory to the Regional Director.

(iii) Nothing in paragraphs 3(f)(i) or 3(f)(ii) shall prohibit the Bank from advancing funds in connection with any Student Loan for which the Bank had a binding commitment to do so prior to the date that any prohibition contained in paragraphs 3(f)(i) or 3(f)(ii) took effect: provided such commitment was made by the Bank in good faith and not for the purpose of evading the prohibitions of paragraphs 3(f)(i) or 3(f)(ii).

4. (a) The Bank shall maintain an allowance for loan and lease losses in accordance with the prevailing requirements of the Instructions for the Reports of Condition and Income ("Instructions").

(b) Reports of Condition and Income required to be submitted by the Bank as of each Report date, as that term is used in the Instructions, between and including November 9, 1989, and the effective date of this ORDER, shall, at a minimum, reflect an allowance for loan and lease losses that should have been maintained in accordance with the Instructions. If necessary to comply with this paragraph, the Bank shall file amended Reports of Condition and Income within 10 days from the effective date of this ORDER.

(c) Prior to the submission of any Report of Condition or Report of Income required to be filed by the Bank after the effective date of this ORDER, the board of directors of the Bank shall: (1) review the adequacy of the Bank's allowance for loan and lease losses, (2) provide for an adequate allowance, and (3) accurately report the allowance in any such Report of Condition and Income. The minutes of the board meeting at which such review is undertaken shall indicate the results of the review, including any increases in the allowance, and the basis for determining the amount of allowance provided.

5. No more than 10 days from the effective date of this ORDER, the Bank: (1) shall eliminate from its books by collection, charge-off, or other proper entries, all assets or portions of assets classified "Loss" as of November 9, 1989; and (2) shall either (A) eliminate from its books by collection, charge-off, or other proper entries, or (B) if the asset is an extension of credit or lease, increase its allowance for loan and lease losses by an amount equal to 50 percent of those assets or portions of assets classified "Doubtful" as of November 9, 1989, which have not been previously collected, charged off, or otherwise eliminated by other proper entries. Reduction of these assets through use of proceeds of loans made by the Bank does not constitute collection for the purpose of this paragraph.

6. (a) No later than July 31, 1991, the Bank shall reduce the aggregate dollar amount of all Student Loans held on the Bank's books more than 120 days to no more than thirty million dollars ($30 000,000) and shall thereafter maintain the aggregate dollar amount of Student Loans held on the Bank's books more than 120 days at or below such level while this ORDER is in effect.

(b) The Bank shall not make, approve, or purchase Student Loans in an aggregate dollar amount in excess of eight million dollars ($8,000,000) in any calendar month; provided, Student Loans to or for the benefit of students attending Institutions which provide an educational program for the award of a baccalaureate, graduate, or professional degree and which are accredited or preaccredited by a nationally recognized accrediting agency or association shall not be included for purposes of the limitation contained in this paragraph 6(b).

(c) The Bank shall not make, approve, or purchase Student Loans to or for the benefit of students attending an Institution if the average principal balance of all Student Loans made, approved, or purchased by the Bank during the preceding 12 calendar months to or for the benefit of students attending such Institution is less than two thousand three hundred dollars. The average principal balance shall be the quotient obtained by dividing the aggregate of the dollar amounts of all Student Loans made by the Bank, to or for the benefit of students attending an Institution by the number of

Student Loans made by the Bank to or for the benefit of students attending such Institution.

(d) The Bank shall not make, approve, or purchase any Student Loan to or for the benefit of any student attending an Institution which has an Institutional Default Rate in excess of 20 percent, as reported in the latest data compiled and issued by the U.S. Department of Education for the Guaranteed Student Loan Programs or as reported in the latest data compiled and issued by the Guarantee Agency which guarantees such Institution's Student Loans.

(e) The Bank shall not make, approve, or purchase any Student Loan which is not guaranteed or reinsured by the Federal government.

(f) The weighted average Institutional Default Rate for all Student Loans made, approved, or purchased by the Bank in any calendar month shall not exceed 10 percent. The weighted average Institutional Default Rate shall be the sum of the products obtained by multiplying the Institutional Default Rate for each Institution by the total dollar amount of Student Loans made by the Bank during the month to students attending that Institution divided by the total dollar amount of Student Loans made by the Bank during the month. The Institutional Default

Rate is derived from the same sources set forth in paragraph 6(d) of this ORDER.

(g) (i) If, during the period this ORDER is in effect, the Bank violates or is not in compliance with the provisions of paragraph 6(a), the Bank shall immediately cease making, approving, or purchasing Student Loans, and shall not, except with the prior written consent of the Regional Director, thereafter make, approve, or purchase, directly or indirectly, any Student Loan until such time as the Bank is in compliance with paragraph 6(a), and provides evidence of such compliance satisfactory to the Regional Director.

(ii) Nothing in paragraph 6(g)(i) shall prohibit the Bank from advancing funds in connection with any Student Loan for which the Bank had a binding commitment to do so prior to the date that any prohibition contained in paragraph 6(g)(i) took effect: provided such commitment was made by the Bank in good faith and not for the purpose of evading the prohibitions of paragraph 6(g)(i).

7. (a) No more than 30 days from the effective date of this ORDER, the board of directors shall develop a written Student Loan policy which shall, at a minimum:

(i) provide for the development of additional secondary markets for the sale of the Bank's Student Loans, including at a minimum, maintaining at all times a primary and one or more auxiliary purchasers of its Student Loans;

(ii) establish goals and strategies to decrease the Bank's reliance on brokered deposits to fund Student Loans, consistent with the Bank's capital plan and the requirements of this ORDER;

(iii) restrict the aggregate dollar amount of Student Loans held on the Bank's books to a level that will enable the Bank to achieve and maintain an equity capital ratio of at least 6 percent at all times;

(iv) require Institutions to meet appropriate requirements before an Institution's students will be eligible for a Student Loan from the Bank, which shall include, at a minimum, a requirement that the Institution meet the default rate requirements of paragraph 6(d);

(v) require that all Student Loans made, approved, or purchased by the Bank have an average principal balance of at least two thousand three hundred dollars ($2,300.00) per Institution;

(vi) require that the Bank's Student Loans be placed for servicing, prior to entering repayment status, with a servicer having an appropriate record of compliance with applicable statutory and regulatory due diligence requirements for Student Loans;

(vii) prohibit the Bank from making, approving, or purchasing any Student Loan which is not guaranteed or reinsured by the Federal government;

(viii) prohibit the use of commissions or other types of incentive compensation by the Bank, or any of its Institution-Affiliated Parties, employees, or agents, in connection with the making of Student Loans; or in lieu thereof, prohibit any Institution-Affiliated Party of the Bank who is compensated on a commissioned or incentive basis from participating in the approval or acceptance of Student Loans;

(ix) establish record keeping and information systems sufficient to ensure the Bank's compliance with applicable statutory and regulatory due diligence requirements, and the requirements of the Guarantee Agency or Agencies providing guaranties of the Bank's Student Loans; and

(x) prohibit the disbursement of funds in connection with any Student Loan, unless (A) prior to such disbursement, the Bank has obtained the guaranty of a Guaranty Agency, (B) such disbursement is made in the manner prescribed by the Guaranty Agency providing the guaranty, and (C) the amounts disbursed do not exceed the amount of the guaranty provided.

(b) The Student Loan policy shall be coordinated with the Bank's investment, funds management, operating, and budget and profit planning policies; with the Bank's other loan policies; and with the Bank's capital plan.

(c) The written Student Loan policy shall be submitted to the Regional Director and the Kansas Bank Commissioner for review and comment within 30 days after the effective date of this ORDER. No more than 30 days after the receipt of any comment from the Regional Director, and after consideration of such comment, the board of directors shall approve the written Student Loan policy and/or any modification thereto made upon consideration of any comment from the Regional Director, which approval shall be recorded in the minutes of the board of directors. Thereafter, the Bank and its Institution-Affiliated Parties shall follow the written Student Loan policy. Any subsequent modification to the written Student Loan policy shall be immediately submitted to the Regional Director and the Kansas Bank Commissioner for review and comment and shall be subject to the requirements of this paragraph 7(c).

8. (a) After the effective date of this ORDER, the volume of Brokered Deposits held by the Bank shall not exceed the volume of such deposits held by the Bank as of November 9, 1989.

(b) After the effective date of this ORDER, and until such time as the average maturity of Brokered Deposits held by the Bank shall be reduced to or below the average maturity of such deposits held by the Bank as of November 9, 1989, the Bank shall not accept, renew, or roll over any Brokered Deposit for a term exceeding three months. Thereafter, the average maturity of Brokered Deposits held by the Bank shall not exceed the average maturity of such deposits held by the Bank as of November 9, 1989.

(c) The Bank shall reduce dollar-for-dollar the aggregate dollar amount of Brokered Deposits held by the Bank as they mature by the amount of any reductions in the aggregate dollar amount of Student Loans held by the Bank as such reductions in Student Loans are from time to time effected.

(d) The Bank shall take all reasonable actions to eliminate all Brokered Deposits from the Bank by July 31, 1991.

9. (a) (i) No more than 30 days after the effective date of this ORDER, and at least annually thereafter, the Bank shall retain a qualified, independent individual or firm with recognized expertise in valuations of mortgage servicing rights ("Appraiser") to provide a written, independent market valuation of the carrying values of the Bank's purchased mortgage servicing rights ("market valuation"). The market valuation shall include consideration of any adjustments necessary to account for any significant changes in original valuation assumptions, including unanticipated prepayments. The name and qualifications of

each such Appraiser considered for employment by the Bank shall be submitted for review by the Regional Director who shall have the right to disapprove such employment in writing within 20 days of receipt of notification.

(ii) Immediately upon receipt of the market valuation required by paragraph 10(a)(i), the Bank shall adjust the carrying value of its purchased mortgage servicing rights as necessary to conform to the market valuation.

(b) The board of directors shall review the book value of the Bank's purchased mortgage servicing rights at least once each calendar quarter after the effective date of this ORDER and shall adjust such book value to an amount that does not exceed the estimated future net servicing income of the rights calculated on a discounted basis and in accordance with generally accepted accounting principles. The results of such review shall be recorded in the minutes of the board of directors.

10. (a) The Bank shall not pay or declare any cash dividends without the prior written consent of the Regional Director and Kansas Bank Commissioner.

(b) The Bank shall not increase the salaries of or pay additional compensation in the form of bonuses or otherwise to any Institution-Affiliated Party who is also a shareholder without the prior written consent of the Regional Director and Kansas Bank Commissioner.

11. No more than 60 days from the effective date of this ORDER, the Bank shall eliminate and/or correct all violations of law and regulations committed by the Bank as described on page 4-1 of the FDIC's Report of Examination of the Bank as of November 9, 1989.

12. No more than 30 days after the effective date of this ORDER, the Bank shall correct all deficiencies in internal routines and controls noted in the FDIC's Report of Examination (Electronic Data Processing) of the Bank as of November 15, 1989.

13. Following the effective date of this ORDER, the Bank shall send to its shareholders a description of this ORDER, (1) in conjunction with the Bank's next shareholder communication, and also (2) in conjunction with its notice or proxy statement preceding the Bank's next shareholder meeting. The description shall fully describe the ORDER in all material respects. The description and any accompanying communication, statement, or notice shall be sent to the FDIC, Registration and Disclosure Unit, Washington, D.C. 20429, for review at least 20 days prior to dissemination to shareholders. Any changes requested to be made by the FDIC shall be made prior to dissemination of the description, communication, notice, or statement.

14. The Bank shall furnish written progress reports to the Regional Director and the Kansas Bank Commissioner detailing the form and manner of any action taken to secure compliance with this ORDER and the results thereof within 10 days after the last business day of each calendar month while this ORDER is in effect. In addition, the Bank shall furnish such reports on request of either the Regional Director or the Kansas Bank Commissioner. All progress reports shall be in such form and contain such information as the Regional Director or the Kansas Bank Commissioner may from time to time require. All progress reports and other written responses required by this ORDER shall be reviewed by the board of directors of the Bank and made a part of the minutes of the board meeting.

This ORDER shall become effective ten (10) days from the date of its issuance.

The provisions of this ORDER shall be binding upon the Bank, its Institution-Affiliated Parties, successors and assigns.

The provisions of this ORDER shall remain effective and enforceable except to the extent that, and until such time as, any provisions of this ORDER shall have been modified, terminated, suspended, or set aside by the FDIC.

Pursuant to delegated authority.
Dated this 18th day of May, 1990.

Charles E. Thacker
Charles E. Thacker
Regional Director
Kansas City Region

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 10

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE INSPECTOR GENERAL

February 14, 1990

Management Improvement Report No. 90-7

TO : Dr. Leonard L. Haynes III
Assistant Secretary
Office of Postsecondary Education

Mitchell L. Laine

FROM : Mitchell L. Laine
Assistant Inspector General for Audit

SUBJECT: Standards Needed To Strengthen Guarantee Agency Lender Reviews

The purpose of this memorandum is to advise you of the need to establish minimum standards for guarantee agency lender reviews. Standards will improve the reviews' quality, consistency and usefulness.

Our comments are based on a preliminary analysis of data provided by guarantee agencies, interviews with U.S. Department of Education (ED) program officials and survey work at four guarantee agencies. The purpose of our ongoing audit is to: (1) determine the extent of guarantee agency compliance with enforcement requirements stated in 34 CFR 682.410(c) and (2) assess the quality of the lender review work performed by the guarantee agencies. While the audit is in the survey phase, our analysis of guarantee agency data gathered so far raised significant concerns which we believe should be addressed as soon as possible. This analysis indicates that neither ED nor the guarantee agencies as a group have addressed the issue of minimum standards for lender reviews. We also identified weaknesses in the method for selecting lenders for review. We are recommending that ED either require Certified Public Accountant (CPA) audits of the top 100 loan holders or set minimum standards for guarantee agency lender reviews.

Guarantee agencies are required to perform biennial on-site reviews of each participating lender whose guaranteed loan volume in the preceding year equaled or exceeded two percent of the total of all loans guaranteed by the agency in that year or was one of the top ten largest lenders whose loans were guaranteed by the

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agency in that year. The first biennial cycle ended December 31, 1988. The second cycle will end December 31, 1990. ED issued lender review guides dated Fall 1987 and Spring 1989 to provide a foundation of procedures for lender reviews. In addition, ED co-sponsored two "Training of Review Staff for Guarantee Agencies" training courses with the National Council of Higher Education Loan Programs. ED program officials also advised us that there is a proposed regulation to require annual financial and compliance audits of the interest and special allowance billings for all lenders whose outstanding guaranteed student loan volume exceeds $50 million.

Issues

The preliminary analyses completed to date surfaced several issues: (1) standards applicable to lender reviews, (2) variability in guarantee agency approaches, (3) review standards not addressed, (4) inherent potential conflict of interest, and (5) ineffective method of selecting lenders.

Standards Applicable To Lender Reviews - Adherence to minimum standards has a direct effect on the quality of guarantee agency lender review results. The preliminary analysis disclosed that neither ED nor the guarantee agencies as a group have identified minimum standards. We believe the following standards are applicable to guarantee agency lender reviews.

1. Staff qualifications - requires that the personnel performing the reviews must collectively possess the necessary knowledge and skills.
2. Independence - requires that reviewers must maintain independence so that their conclusions and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties. Independence can be affected by personal and external impairments and organizational structure. Personal impairments are circumstances in which staff are not impartial or are not perceived to be impartial. External impairments are factors which may restrict or interfere with the reviewer's ability to form independent conclusions. The reviewers need to be sufficiently removed from organizational pressures to ensure that they can conduct reviews and report the results objectively without fear of repercussion.
3. Due care - requires the reviewer to use sound judgement in establishing the scope, selecting the methodology, and choosing the tests and procedures for the review. The same sound judgement must be applied in conducting the tests and procedures and in evaluating and reporting the review results.
4. Quality control - requires a system to assure that the reviewer (1) has established and is following adequate

policies and procedures and (2) has adopted and is following adequate standards. The quality control system may include both an internal system and participation in an external system.

5. Planning - requires thorough planning of the review. Planning includes consideration of the objectives, scope, methodology and staff to be used in the review.

6. Evidence - requires that the reviewer obtain sufficient, competent and relevant evidence to support all conclusions and findings. A record of the work should be retained in the form of working papers. Working papers are the link between work and the report. Agencies need to establish policies and procedures to assure safe custody and retention of the working papers for a reasonable time period. Working papers should (1) contain the review procedures cross indexed to the working papers, (2) contain adequate indexing, cross-referencing, schedules and summaries, (3) be dated and signed by the preparer, (4) document supervisory review, (5) be understandable without oral explanation, and (6) be legible.

7. Supervision - requires staff to be properly supervised. Supervisory reviews of work should be timely and determine whether (1) the work conformed to applicable standards, (2) the procedures were followed, (3) the work was conducted with due care, (4) the working papers adequately support findings and conclusions and provide sufficient data to prepare a meaningful report, and (5) the objectives are met. Supervisory reviews should be documented in the working papers.

8. Reporting - requires that the report should be complete, accurate, objective, convincing, clear and concise. Completeness requires that the report contain all pertinent information necessary to give readers an adequate and correct understanding. This means providing perspective on the extent and significance of reported findings, such as the frequency of occurrence relative to the number of cases or transactions tested.

Variability In Guarantee Agency Approaches To Lender Reviews - The data provided by guarantee agencies disclosed that there is a high degree of variability in the way guarantee agencies implemented the lender review requirement. We identified at least two agencies which did not perform lender reviews during the first biennial cycle and six agencies which reported less than the minimum number of ten reviews. Most agencies used internal staff to perform the reviews. However, a few agencies contracted with another guarantee agency to perform the reviews and at least one agency contracted with a CPA firm. There was also a great deal of variability in the agencies' approaches to the reviews when compared to the standards identified above.

While many agencies had set minimum staff qualifications some had not. For the agencies with minimum staff qualifications, there was considerable variation in the standards set. Qualification standards were generally stated in terms of a mix of education and/or prior experience. Because experience can be substituted for education and vice versa, there may not be a specific minimum amount of either education or experience required. The qualifications of current review staff ranged from a high school diploma with some prior student loan experience to CPAs with graduate degrees and considerable experience. Most agencies did not have a continuing education requirement. Approximately half of the agencies did not provide internal training prior to assigning staff to fieldwork. However, most agencies did indicate that some staff members had attended continuing education courses.

Most guarantee agencies did not have procedures to detect personal or external impairments to the reviewer's independence. Most agencies had adequately placed their review units in the organization structure to reduce fear of repercussions within the organization. However, as discussed later, there is an inherent conflict of interest in guarantee agency lender reviews which impacts at least the perceived independence of reviewers. The potential conflict is increased when the guarantee agency or a related corporation provides loan servicing to the lenders under review. In these cases, the guarantee agency reviews itself.

Individual agencies took 2 to 31 staff days on average to perform a review. The average for all agencies was approximately 8.4 staff days. This data indicates there is a great deal of variation in the extent of testing and analysis performed by the reviewers.

Most guarantee agencies indicated they had established a quality control system for lender reviews. The supporting information generally indicated the agencies were referring to the coverage of the review function provided by the required financial and compliance audit of guarantee agencies. It is questionable whether these reviews meet the intent of a quality control system. One agency reported their internal audit unit performed a quality control review and one agency reported hiring a CPA to perform a quality control review.

As previously noted, ED issued two guides for performing lender reviews. Most guarantee agencies had also developed written guides for performing lender reviews. Like the ED guide, the agency guides generally discussed areas to be tested but did not identify specific tests to be performed. Many of the agencies guides included standard questionnaires for review of lenders' procedures and standard work papers for the review of individual files. In a few cases, we were provided examples of completed working papers. Generally, these working papers were not sufficient to stand alone without further explanation. The papers did not identify the source of the information or conclusion drawn as a result of the work. Most agencies did prepare working papers and retain them for a reasonable period of time.

The data provided by guarantee agencies indicated that supervisory reviews were generally limited to the report and possibly the working papers related to the findings. Approximately one third of the agencies indicated there was no review of the working papers. The comments provided indicated that the supervisory review was limited unless a lender did not concur with the results.

We reviewed examples of the lender reports issued by several guarantee agencies. Generally, the usefulness of the reports was limited because they did not provide sufficient information for the reader to assess the significance of the findings reported. The reports were generally a collection of comments on the individual files reviewed. The reports did not state the reviewer's conclusions on the overall adequacy of the lender's administrative capability, system of internal controls or records. Recommendations were limited to correcting the deficiencies cited in the individual files. When an adjustment was requested, the amount often was not specified. The reports did not adequately relate the reviewer's results to the size of the sample, size of the sampling universe from which the sample was drawn, and the size of the lender's portfolio. The reports generally did not identify the period covered by review.

ED's Guidance Does Not Address Review Standards - The lender site review guides issued by ED recommend procedures for organizing, conducting and closing the review. The guide identifies eight core items which must be addressed as part of the review and discusses areas which should be addressed in the review. However, the guide generally does not set minimum performance standards. The guide does not address the standards of staff qualifications, independence, due care, quality control, evidence, or supervision. The guide sections on organizing the review and closing the review address the planning and reporting standards. The chapter on in-house preparation provides a comprehensive list of procedures for planning the review. However, the chapter on the written report merely provides a recommended format for the report. The chapter does not set minimum standards for guarantee agency lender review reports.

Inherent Potential Conflict Of Interest - A significant portion of guarantee agency revenues is dependent on recruiting and retaining lenders which use the agency to guarantee loans. Due to the existence of regional and national guarantee agencies, lenders generally have several guarantee agencies with which they can choose to guarantee their loans. Therefore, a guarantee agency which performs a lender review which results in a significant financial liability may risk losing the revenue which it receives from guaranteeing the lender's portfolio. This inherent conflict of interest may influence the quality of reviews by guarantee agencies.

Method Of Selecting Lenders For Review - The guaranteed student loan program portfolio totaled $45.1 billion as of September 30, 1988. The portfolio is held by 13,000 loan holders. However, the top 100 loan holders account for $32.5 billion or 72 percent of the entire portfolio. The portfolio sizes for the top 100 range from $11.3 billion to $67.6 million.

The current regulations select lenders for review based on the volume of loans guaranteed in the preceding year. Since many lenders sell the loans shortly after origination, this criteria may result in reviews of lenders with relatively small loan portfolios while omitting reviews of relatively large loan holders such as secondary markets. Lenders which sell loans generally sell prior to the loan entering repayment. Conversion to repayment is the point at which administrative costs and the risk of servicing errors which could adversely affect ED's interests increase significantly. Therefore, there is a significant level of risk related to the loan holders not included in the current selection criteria.

ED program personnel indicated that the intent of the current regulations was to provide coverage of the large lenders in the program. Since ED currently has over 50 reinsurance agreements and the minimum of ten lender reviews is required for each agreement, over 500 reviews are required by the current regulations. This greatly exceeds the number of reviews required to cover the loan holders with the largest portfolios. Using guarantee agency volume as the selection criteria does not necessarily target the large lenders because the size of the guarantee agencies varies greatly. In addition, many loan holders use more than one guarantee agency. Therefore, more than one agency may be required to review a given lender. Selection based on the size of the outstanding portfolio would result in more efficient coverage of the guaranteed student loan portfolio.

Potential Impact On The Quality Of Lender Reviews

The quality of lender reviews and the related reports depends upon whether (1) review scope, methodology, tests and procedures are adequate; (2) findings and conclusions are based upon objective evaluation of pertinent evidence; and reports are fully supported by sufficient, competent and relevant evidence; and (3) findings and conclusions are communicated in sufficient detail to allow readers to put them in the proper perspective.

Without minimum standards, poor quality reviews are more likely. A poor quality review may fail to detect and/or resolve non-compliance. A review which is inadequately planned or performed by unqualified staff is more likely to fail to detect non-compliance. A report which is not supported by adequate evidence or which fails to convey the significance of the findings is unlikely to resolve the non-compliance which the reviewer detected. Poor quality reviews reduce the control over the

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accuracy of interest and special allowance billings and lender implementation of due diligence requirements which ED gains from guarantee agency lender reviews.

In addition, the current reviews lack consistency. The lack of consistency reduces the usefulness of the reports to ED in assessing compliance with guaranteed student loan program regulations. Readers do not have assurance that a minimum set of procedures were performed.

The current method of selecting lenders for review adversely impacts the overall quality of the reviews. Secondary markets which hold a significant portion of the guaranteed student loan program portfolio are omitted. Secondly, the method does not efficiently target the largest loan holders which control the majority of the portfolio.

Recommendations

We recommend that ED:

1. Modify the requirement for guarantee agency lender reviews to require periodic audits of participating loan holders with the 100 largest outstanding portfolios. These audits should be performed by a CPA in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, and with an audit guide prepared by ED covering the lenders' administration of the guaranteed student loan programs.

2. Issue an audit guide which sets forth the minimum procedures necessary to perform a lender audit.
    a. The guide should consider the needs of all users including ED, guarantee agencies and loan holders.
    b. Require that the reports be submitted to ED and subjected to desk review and quality control procedures.
    c. Require that users including ED and guarantee agencies have access to the working papers.

OR

3. Establish minimum standards in each of the standard areas applicable to guarantee agency lender reviews:
    a. Staff qualifications.
    b. Independence.
    g. Due care.
    c. Quality control.
    d. Planning.
    e. Evidence.
    f. Supervision.
    h. Reporting.

4. Revise the lender review guide to improve the comparability and usefulness of the lender review reports. Revisions needed include:
   a. Clearly define the tests all guarantee agencies are expected to perform.
   b. Standardize the working paper format and content for tests that all guarantee agencies are expected to perform.
   c. Standardize the period covered by a lender review and the universe from which sample files are selected.
   d. Standardize the report format so that:
      1. The size of the lender's portfolio and portion of the portfolio covered by the review are clearly and consistently identified.
      2. Any findings clearly relate the sample results to the period covered, the size of the sample, the sampling universe and the lenders total portfolio.

   This will permit the reader to put the results in the proper perspective and assess whether or not follow-on work is necessary.

We believe that replacing guarantee agency lender reviews with CPA audits of the 100 largest portfolios is the most effective and efficient approach to improving the quality of lender reviews. The benefits of requiring CPA audits include:

1. The approach focuses coverage on the large guaranteed student loan program portfolios while reducing the total number of reviews required. The audits will cover over 70 percent of the outstanding guaranteed student loan program portfolio.
2. Applicable standards already exist for CPA audits.
3. The approach eliminates the potential conflict of interest associated with guarantee agency reviews of lenders.
4. The approach would cause minimal additional cost to lenders and may reduce the number of reviews required. The financial auditors for lenders with large guaranteed student portfolios should already review the lenders' compliance because the portfolio represents a significant portion of the lenders' total portfolio. Since other reviewers could choose to rely on the audit to restrict their work, the cost associated with these reviews may be reduced.
5. The approach allows guarantee agencies to focus their lender review resources on lenders which they consider to be high risks.

Program officials have indicated to us that, in dealing with the issues noted in this report, they will also have to consider any changes that may occur to individual programs as a result of the current reauthorization process.

We would appreciate your review and comments concerning our recommendations within 30 days of the above date. If you have any questions or would like to discuss our recommendations, please contact Carol Lynch, Chief, Postsecondary Education Audit Branch, on 732-5848.

Senate Permanent Subcommittee
on Investigations
EXHIBIT # 13

AFFIDAVIT
OF
THERESA SANDOVAL ROBERTSON

My name is Theresa Sandoval Robertson, and I live in Sacramento, California. I am 37 years old and a former employee of First Independent Trust Company (FITCO). I began my career at FITCO as a corporate bookkeeper in February, 1979, when I was hired by Cyril "Chris" Marelia, an officer of the company. My employment at FITCO ended in 1986 when I was terminated from my position as chief accounting officer. Prior to FITCO, I worked for several years as a full charge bookkeeper with a CPA firm in Sacramento. In addition, I have taken several business courses to further my accounting education, although I have no high school diploma or GED certificate.

When I was hired by Marelia, my duties included the general bookkeeping of the corporate side of FITCO. By the time I was terminated, I had moved from the corporate side of FITCO to the trust department and had served in a variety of functions within each. In 1980, I was given the title of chief accounting officer. In the later years of my employment with FITCO, my role was that of a "troubleshooter" -- one familiar with the various operations within FITCO and relied upon to solve accounting problems that arose, no matter what the department. Because of this role, I acquired knowledge of virtually all of the operations within the trust company. It was this extensive knowledge of the operations at FITCO, both legal and illegal, that I believe eventually led to my dismissal from the company.

Prior to its involvement in student loans, FITCO earned income from trust fees charged the trustors, from court accounts (accounts awarded to FITCO from probate court), IRA's, KEOGH's, corporate pension, and private accounts.

To my knowledge, Deno Evangelista, the president and chairman of the board of FITCO, was motivated to become involved in the student loan program as a result of conversations with Bill Kettle, who, at the time, was the owner of Bauder College, a proprietary school operating in Sacramento. In the early 1980s, when Evangelista started making student loans from trustors' monies, the trustors were not aware that their money was being invested in such loans. Investors' statements merely read that the money was invested in "G.F.I.F.," which stood for Government Financial Institutional Fund. There was no explicit mention of student loans. At that time, there were only 13 people in the company, with four or five working in the student loan department.

When FITCO first became active as a lender in the student loan program, there was no secondary market in which to sell the loans. Therefore, FITCO was holding and servicing its loans. These loans were guaranteed or insured by California's guarantee agency, the California Student Aid Commission (CSAC), for a fee of approximately 1% of the loan value. CSAC helped teach the FITCO employees how to service the loans, i.e., what is required in performing "due diligence" in the collection of a loan. When the secondary market did develop, FITCO began processing an enormous number of student loans. To accommodate our rapid growth, the student loan department grew to nearly 90 people. This volume was sold mainly to the California Student Loan Finance Corporation (CSLFC) at the face value of the loan plus 1%. From 1980 through approximately July, 1985, I processed the majority of the sales to the secondary market. Loans were always sold whole, and, if there were multiple disbursements, I waited until the last disbursement had been made before selling. CSLFC's loan servicer was UES, or United Education and Software.

As the demand for student loans increased, FITCO eventually exhausted its trust resources for making the loans. It became necessary for FITCO to immediately sell to the secondary market the student loans it had made, thus generating more money with which to make additional loans. In the beginning, loans were sold to the secondary market within approximately a week. Later, loans were sold so quickly that, often, the loan check had not yet cleared the bank before FITCO sold the loan to the secondary market. FITCO even increased its selling speed to the point that loans were routinely sold within hours. However, selling loans this quickly did not give the student time to cancel if he or she decided not to attend school. If a student was to cancel the loan, it was likely his loan had already been sold, and, therefore, credit had to be forwarded to the secondary market "holding" the paper.

I discovered, in preparing for an audit by CSAC and the California State Banking Department (CSB) in the Spring of 1986, that a great volume of cancelled loans and loan refunds had not been forwarded to the secondary market. Not only did this include students who had decided not to attend school at all, but it also encompassed those students who had left school before the term was complete and were due a partial refund. I requested a check for approximately $1.8 million from FITCO's accounting department in order to forward these refunds to the secondary market/"holding" institution, but my request was denied. I discovered that the cash due the secondary market was not accessible, because, as FITCO's accounting department told me, the money was tied up in corporate certificates of deposit that had not yet matured. Trust monies, from which the student loans were made, were, by law, never to be commingled with corporate accounts. I am not sure when, or if, these refunds were ever made. There was also a very large quantity of cancelled checks that had to be refunded to the secondary market; however, I am not sure what the dollar amount was, or if those refunds were ever made.

In making a loan to a student, the lender must pay the U.S. Department of Education (ED) an origination fee, which is 5% of the dollar amount of the loan. Also, an approximate 1% premium is paid to the guarantee agency for insurance on the loan. Both of these fees originally were maintained in separate accounts for payment to ED and the guarantee agency. Origination fees were in an account called "GOF," or Government Origination Fee. Additionally, when a loan is made, the Government pays to the lender a fee for special allowance and interest. I learned that, in most cases, the Government's payments to the lender for special interest and allowance for a quarter are greater than the origination fees that are owed by the lender. ED allows the two fees to offset each other, so that ED owes only a small portion to the lender each quarter. However, this was not the situation with FITCO.

Because FITCO was originating a very high volume of loans, as well as selling the loans quickly, it was not collecting much special interest and allowance. In the first quarter of 1982, for the first time, FITCO's origination fees owed to ED exceeded the special interest and allowance due from ED. This continued to be the situation during the time I was employed there.

This situation apparently had created a problem for the Department of Education. For each quarter, FITCO submitted to the Department a Form 799, which reflected the volume of loans made, the amount of origination fees FITCO owed, as well as the special interest and allowance FITCO was due. When it was discovered by FITCO that FITCO owed ED origination fees over and above the amount of special interest and allowance owed FITCO, a check for approximately $16,000 was mailed to the Department, along with the Form 799. Because special interest and allowance due most lenders exceedes the 5% origination fees collected, ED was not accustomed to receiving monies and did not know how to process the incoming funds. ED apparently believed there would eventually be an offset that would eliminate the need to process these funds. This, however, was not the case with FITCO. As long as I worked at FITCO, quarterly 799 reports from FITCO continued to go to ED showing monies owed by FITCO to ED. To my knowledge the Department of Education never attempted to collect the excess origination fees.

When I left FITCO in 1986, the GOF account had grown to a sizable sum. I was told that Evangelista had moved the GOF account from Central Bank to Bank of America. As far as I knew, FITCO was submitting its quarterly 799's to the Department of Education, yet no fees were being paid because ED would not accept the funds. I know that the forms were submitted, because from 1980 to the second quarter of 1985, I was responsible for submitting or reviewing the majority of these forms.

In preparing FITCO for the 1986 audit that was previously mentioned, I was given the task of "cleaning up" student loans at FITCO. The FITCO officers located at its La Sierra office knew it was essential that the trust company pass the upcoming audit and, thus, agreed to create a student loan compliance department to be headed by me, under the direction of the chief financial officer, Randy Dreith. I had pointed out to Dreith that FITCO must make an effort to tackle the problems that we knew existed. It was at this point that the refund situation came to light. Additionally, other problems surfaced at FITCO, such as the failure to balance the trust bank accounts and student loans for nearly two-and-a-half years. In the La Sierra Building, which was FITCO's processing center, I learned staffers had erroneously shredded copies of student loan documents for a period of approximately six months. I learned upon further investigation that occasionally even original documents were erroneously shredded. Also, the student loan department found incomplete student loan files which led to the "creation" of duplicate documents. This often resulted in loans being double- and triple-funded after recreation. Consequently, a student who had taken out a $2500 loan would receive $5000. The double-funded loan would only be guaranteed by CSAC for the originally intended amount ($2,500), so if the student defaulted on the loan, it was the trustor who suffered. I also found that promissory notes were often signed by the student's after their loan check had been negotiated by them. This was a violation of the federal regulations. I was aware that, at times, interest that was due trustors on their investments was paid from the GOF account, which contained the 5% origination fees. I also learned that the 5% Government origination fees were being placed in interest bearing accounts under the corporation's name in order to earn interest income for the corporation.

In the course of the 1986 audit, I told officials from CSAC about some of these problems, but they seemed satisfied that I was working to resolve them. At this point, Glenn Bigelow, Evangelista's son-in-law and the FITCO executive vice-president, was in charge of the student loan division. I told Bigelow, Dreith, Evangelista, and any other officers of the company that I

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could find about the irregularities at FITCO. I saw little or no action being taken to resolve them, other than the effort I was making to get through the audit.

Despite a promise that I could continue the student loan compliance department that I had initiated, the department was dismantled after FITCO passed the audit, and I was demoted to a data operator position. I feel this happened because of Glenn Bigelow, who was threatened by my knowledge of the company's inefficient operations and my insistence that problems be rectified. He also knew that I was displeased with his attitude of "making money quickly by any means." I was terminated in July, 1986.

An additional event that should be brought to the Subcommittee's attention occurred in the early 1980s. At this time it came to my attention that student loan checks returning endorsed from a particular school had forged student signatures; signatures that did not match those on the promisory notes we had on file. After a student called to complain, I brought this to Evangelsita's attention. I was told by Evangelista that the student loan checks from this particular school should continue to be processed until someone from the Department of Education detected the forgeries and told FITCO to stop. Fortunately, the Department soon discovered this was happening.

Other situations that I was aware of at FITCO were not limited to the student loan department. It was common knowledge that Evangelista made numerous unsecured loans to area judges and influential friends. He also claimed to have the ability to delay reviews or audits conducted by the California State Banking Department. In fact, I believed this to be true in that there was a period of several years during which CSB did not audit FITCO. I also had knowledge of Evangelista's "juggling the books." He moved money from one account to another to replace capital or to borrow from trustors' accounts to make unapproved investments. If there had ever come a time when all the trustors or investors of FITCO wanted to remove their funds, the money simply would not have been there. Evangelista knew the possibility of this happening was unlikely and, thus, felt in control of his activities.

Shortly after I was terminated in 1986, my attorney, at my request, wrote to Government officials to make them aware of the irregularities at FITCO. This included the U.S. Department of Education located in Region IX, the U.S. Attorney's Office in Sacramento, the Attorney General's Office, and the California State Banking Department.

I have read, reviewed, and initialled each page of this statement consisting of 10 pages, and I swear, to the best of my knowledge and belief, that the statements contained herein are true and correct.

Theresa Sandoval Robertson

Theresa Sandoval Robertson

Sworn to and subscribed before me
this 21st day of ~~August~~ September, 1990.

Notary Public
My commission expires

7-4-93

OFFICIAL SEAL
SUSAN T. HATLER

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 16

UES
United
Education &
Software

Executive Offices
15720 Ventura Boulevard
Encino, California 91436-2972
818 907-6648

Loans
Made by FITCO –

Curricula designed by FITCO
Audit is controlled by FITCO

November 26, 1986

Mr. John Keefe, Chief
Guarantee Agency and Lender Review
Branch
United States Department of Education
Office of Postsecondary Education
50 United National Plaza - Region IX
San Francisco, CA 94102

Dear Mr. Keefe:

Please let this letter serve as written confirmation of our telephone conversation of November 26, 1986.

In that conversation, you stated that as of this date (11/26/86), as a result of The Higher Education Reauthorization Act of 1986, which supercedes all regulations issued to this date, that UES is allowed to service all aspects of the processing and administration of Guaranteed Student Loans made by eligible lenders to students enrolled in UES owned eligible Institutions, as well as other eligible Institutions, without the necessity of executing an Origination Agreement with The Secretary.

Those provisions that precluded UES from acting as a servicer for lenders that make Guaranteed Student Loans for students in UES owned schools no longer apply.

Please acknowledge your concurrence of the above statement by signing in the space provided and returning a copy of this letter to me, so that we may have a written record upon which to rely, in case this matter ever comes into question.

Thank you very much for all your efforts in resolving this matter.

Sincerely,

Aaron Cohen
President

AC:e

John H Keefe 11/28/86
John Keefe Date

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AUG 16 1984

File

Mr. Aaron Cohen, President
United Education and Software
15720 Ventura Boulevard
Encino, CA 91436

Dear Aaron:

Your letter of July 5, 1984 concerning loans to various UES schools and their handling by First Independent Trust has been received. This process you have outlined in this letter does not present us with any problems.

As we discussed the fact that UES is not processing UES student's loans but, sending them directly to the bank, eliminates any conflict with regulation 682.601. As long as there is no processing on UES's part there will not be any origination conflict.

If you have any further questions or we can be of assistance do not hesitate to contact us again.

Sincerely yours,

John H. Keefe
Chief
Guarantee Agency and
Lender Review Branch

cc: California Educational Loan Program

CALIFORNIA
STUDENT
LOAN
FINANCE
CORPORATION
A Non-Profit
Public Benefit
Organization

LENDER ORIGINATION/
SERVICING
(CODE 104660)

9570 West Pico Boulevard, Suite 200, Los Angeles, CA 90035 (213) 271-1135

Please file in UES & [illegible]

Copy to UES file (school)
UES file (servicer)
CSLFC file (owner)
Dave/Ken/Randy/Compliance [illegible]

[illegible]

C. Dir
7/17

Documentation showing UES [illegible] [illegible] schools

TELECOMMUNICATION MEMORANDUM:

Date: 2-10-88 Time: 2:05

To: RICK REINHARDT No. of Pages: 1 +this form.

From: TRENT NEBEKER

Telecopier # 213/271-5024

Telecopied by: DAVE

Call 213/271-1135 if any questions or difficulty.

Source Sydney Jo[illegible] CSAC, Spec[illegible]
Program Quality Assurance (916)324-2294

Purpose To show that UES was allowed to service loans for students attending their schools

1/2

R. Stav[illegible]
9/13/

UES

United
Education &
Software

Executive Offices
15720 Ventura Boulevard
Encino, California 91436-2977
818 907-6848

Loans
Made by FITCC -

Checks signed by FITCC
Acct is controlled by
FITCC.

November 26, 1986

Mr. John Keefe, Chief
Guarantee Agency and Lender Review
  Branch
United States Department of Education
Office of Postsecondary Education
50 United National Plaza - Region IX
San Francisco, CA 94102

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Thank you very much for all your efforts in resolving this matter.

Sincerely,

Aaron Cohen
President

AC:e

John H Keefe 11/28/86
John Keefe Date

AUG 16 1984

Mr. Aaron Cohen, President
United Education and Software
15720 Ventura Boulevard
Encino, CA 91436

Dear Aaron:

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If you have any further questions or we can be of assistance do not hesitate to contact us again.

Sincerely yours,

John H. Keefe
Chief
Guarantee Agency and
Lender Review Branch

cc: California Educational Loan Program

HEAF

Higher Education Assistance Foundation
Suite 500
85 East Seventh Place
Saint Paul, Minnesota 55101-2173
612-227-7661

A member of the HEAF grou

VIA TELECOPIER

Senate Permanent Subcommittee on Investigations

EXHIBIT # 18

May 1, 1989

CERTIFIED MAIL
P 571-010-677

Mr. Deno Evangelista
President
First Independent Trust Company
5325 Engle Road
Carmichael, CA 95608

Dear Mr. Evangelista:

You are hereby notified that the Higher Education Assistance Foundation (Foundation) immediately suspends First Independent Trust Company (FITC) from participation in the Stafford Student Loan Program, the Supplemental Loans to Students Program and the Parent Loan Program. This action is in accordance with the Foundation's Rules and Regulations and Section V of Foundation Bulletin L/S #61, dated January 26, 1988.

The Foundation conducted a program review of FITC on April 10 through the 20, 1989. The review noted serious and ongoing problems at FITC which are the basis for this action. The major findings of the review are as follows:

I. FITC fails to promptly transmit refund payments to the current holder of the loan as required by 34 CFR §682.209(e).

A. Undeposited Refunds

During the review, it was observed that borrower refund checks dated as early as December 1988, were lying unsecured on a bookcase next to an open door of the Trust Accounting Department. The refund checks were batched into 17 separate batches with the average amount of refunds in each batch totalling $326,955 (based on totals of two batches). The total amount of undeposited refund checks was estimated to be in excess of $4,000,000. The receipt of these checks had not been recorded in any manner; therefore, the loss or theft of any of these checks would not have been detected. No effort was being made by FITC to either apply the funds to the borrowers' accounts or to forward the funds to the appropriate secondary market. Certain of the refunds were for full cancellations of the borrower's loan.

Guaranteeing the Future

FITC began depositing these checks on April 12, 1989. After reviewing the deposit slips from April 12 through April 18, it was determined that FITC had deposited $565,929. The remaining checks were undeposited as of April 21, 1989.

B. Refunds Held by FITC and Not Forwarded to the Current Holder

As of the date of the review, FITC records indicated nearly $1,300,000 in refunds received prior to July 31, 1988 but not yet remitted to the current holder of the loans. Many of these refunds have been held by FITC since as early as 1985. FITC explained that many of these borrowers could not be located on its system. However, in reviewing a selected sample of refunds not remitted, it was determined that the loans were readily identifiable on the Foundation's data base. In certain instances the Foundation has paid a default claim on a loan for which a refund was paid by the school but never forwarded by FITC.

C. Delayed Forwarding of Refunds to Current Holders

According to FITC officials, refunds are forwarded to the current holder within five to ten working days. However, of 143 refunds reviewed, only 41, 29%, were refunded within 14 days. Seventy, 49%, were not forwarded within 30 days with some refunds taking as long as 246 days to process. Although FITC earns interest on the refund amounts held by it, it does not forward this interest to the current holder (for application to the borrower's account) when the monies are remitted. The failure to forward refund checks in a timely manner has caused substantial overbilling of interest both to the borrowers and the Department of Education, and has resulted in higher claim payments being made by the Foundation and reinsurance payments being made by the Department of Education.

II. FITC fails to cancel loans in a timely manner when the loan check is returned or the loan is repaid in full within 120 days of disbursement.

FITC has systematically failed to timely notify secondary markets and the Foundation of the cancellation of loans, and has even failed to note the cancellation on its own system. The result is that the same loan may be listed in up to three different statuses on the systems of FITC, the current holder, and the Foundation, causing inaccuracies in billing the borrower and the Department of Education.

Until recently, cancellations sent to the secondary markets by FITC were not identified as such on the reports. Rather, they appeared only as refunds to be applied to the borrowers' accounts. Because FITC did not remit the origination and guarantee fees along with the cancellation, the current holder applied the cancellation monies as a partial refund on the account. The borrowers are receiving collection activity on these accounts and face the negative consequences of default on loans which were never cashed or which were paid in full within 120 days of disbursement.

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The review noted that returned loan checks were not promptly processed as cancellations. The failure to cancel a loan in a timely fashion causes the Department of Education to be overbilled for interest and special allowance and, if delayed long enough, subjects the borrower to collection activities on proceeds of a loan which were never accepted by the borrower.

III. FITC has failed to file Quarterly Interest and Special Allowance Reports (ED 799) and make payment on origination fees owed to the Department of Education pursuant to 34 CFR §682.304.

FITC has failed to pay the Department of Education for origination fees for the past five quarters, beginning with January 1, 1988. The amount of origination fees outstanding for 1988, according to FITC's general ledger, is approximately $4,642,332.

IV. FITC has failed to pay outstanding guarantee fees to the Foundation.

According to the Foundation's records, guarantee fees in the amount of $1,996,300.96 remain outstanding on FITC-originated loans. While FITC believes that the majority of these fees (approximately $1.1 million) are not owing due to the failure of secondary markets to report cancellations to the Foundation, it is apparent that FITC's initial processing of those cancellations contributed greatly to the secondary markets' failure to cancel (see Finding II above). Since December, 1988, the Foundation has made numerous demands for payment, engaged in several attempts to reconcile FITC's data base at the Foundation's, and initiated reconcilation projects with the secondary markets. Despite these efforts, the fees remain unpaid.

The Foundation has determined that the violations listed above are of such seriousness and magnitude that there is likelihood of substantial loss to the borrowers, the Foundation and the Department of Education.

As a consequence of the immediate suspension, the Foundation will not guarantee any loans for FITC after the date of this letter. In addition, a demand is hereby made for payment by FITC of all sums due and owing as noted above.

The immediate suspension is effective as of the date of this letter and will remain in effect until May 30, 1989. Should the Foundation begin a limitation, suspension or termination proceeding during the 30 days of the immediate suspension, the immediate suspension will be extended until the conclusion of such limitation, suspension or termination action. If such action is initiated, the Foundation will, at FITC's request, provide FITC with an opportunity to demonstrate that emergency action in the form of an immediate suspension is unwarranted.

A complete program review report will be issued within the next 30 days detailing the above violations as well as other findings of the review. For your information, a copy of Bulletin L/S #61 is enclosed.

Sincerely,

Wendie J. Doyle

Wendie J. Doyle
Assistant Vice President

WJD:tab

Enclosure

bc: Mr. Dick Hawk, Chairman of the Board
Higher Education Assistance Foundation

Mr. Garry Hays, President
Higher Education Assistance Foundation

Val Vikmanis, Vice President Finance
Higher Education Assistance Foundation

Leslie Frost, Assistant General Counsel
Higher Education Assistance Foundation

Susan Barrett, Compliance Specialist
Higher Education Assistance Foundation

Dr. Samuel Kipp, III, Executive Director
California Student Aid Commission

Mr. Sefton Boyars, Regional Inspector General for Audit
U.S. Department of Education

Mr. Ronald D. Lipton, Chief
U.S. Department of Education

Mr. Fred Brill, Staff Services Manager
California Student Aid Commission

HIGHER EDUCATION ASSISTANCE FOUNDATION

BULLETIN L/S No. 61

TO: Lenders and Schools **DATE:** January 26, 1988

SUBJECT: Limitation, Suspension or Termination of Participant Eligibility

HEAF recently distributed to our lenders and schools the updated and revised HEAF Lender School Administrative Guide. This Bulletin should be inserted into the Bulletin section of the new notebook. HEAF is currently in the process of revising its Limitation, Suspension or Termination Rules and Procedures; however, until those rules and procedures are finalized, the following shall continue to be in full force and effect. These rules and procedures are consistent with the prior rules except that the GSL and SLS/PLUS rules have been combined.

LIMITATION, SUSPENSION OR TERMINATION OF PARTICIPANT ELIGIBILITY RULES AND PROCEDURES

1. Purpose and Scope. These provisions establish rules and procedures for the limitation, suspension or termination of the eligibility of an otherwise eligible lender to obtain guarantees from HEAF for GSL, SLS and PLUS loans or schools to participate in the program. Provisions herein apply to a lender or school which violates any provision of the Higher Education Act of 1965, as amended (the "Act") or any regulation, special arrangement, agreement or limitation prescribed under the above. They do not apply to a determination that an organization fails to meet the definition of a lender or school, nor to a school's loss of lending eligibility due to its default experience, nor to administrative action taken by the U.S. Department of Education.

2. Definitions. For purposes of this section, the following are the definitions of major terms used herein:

   A. "Participant" means an otherwise eligible lender or school.

   B. "Designated HEAF Official" means an individual specifically named or designated by title or position to whom the responsibility for initiating and pursuing limitation, suspension, and termination procedures has been delegated.

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C. "Limitation" means the continuation of a participant's eligibility, subject to compliance with special conditions set by HEAF as a result of a limitation-termination proceeding.

D. "Presiding Officer" means an impartial person who has no prior involvement with the facts giving rise to a limitation, suspension or termination proceeding and who is selected by the President of HEAF to conduct the hearing.

E. "Suspension" means the removal of the participant's eligibility for a specified period of time or until the lender meets certain requirements.

F. "Termination" means the removal of a participant's eligibility for an indefinite period of time.

3. Effect on Prior Participation. Limitation, suspension, or termination proceedings do not affect the responsibilities or rights of a lender or school that are based on the participant's prior participation in the program.

4. Informal Compliance Procedure. If HEAF receives a complaint, or other information that HEAF believes to be reliable, indicating the lender or school may be violating applicable laws, regulations, special arrangements, agreements or limitations, HEAF may give the school or lender a reasonable opportunity to either respond to the complaint, show that the matter has been corrected, or submit an acceptable plan to correct the violation and prevent its recurrence. Limitation, suspension or termination procedures need not be delayed during the informal compliance procedure if HEAF believes the delay would harm the GSL, SLS and PLUS programs or would not correct the alleged violation.

5. Emergency Action. Immediate suspension may be imposed by a designated HEAF official on a GSL, SLS and PLUS programs lender or school when it is determined that the alleged violation is of a magnitude and/or severity to create a likelihood of substantial losses to HEAF, the Federal Government, or students. The designated HEAF official making the determination notifies the lender or school suspended by certified mail, with return receipt requested, of the action and the reasons for same. The effective date of suspension is the date the notice is mailed. Limitations on emergency suspension action are as follows:

A. The emergency action may not exceed 30 days unless a limitation, suspension or termination proceeding is begun before the emergency action period expires. In such an instance, the action may be extended until the completion of the process, including any appeal that may be made to HEAF.

B. If a limitation, suspension or termination proceeding is begun, HEAF provides the school or lenders, upon request, an opportunit to demonstrate that the emergency action is unwarranted according to the terms and conditions of such action as herein set forth.

6. Suspension. This action is limited to a period of time not exceeding 60 days unless the participant involved and the designated HEAF official agree to an extension or the designated HEAF official commences limitation or termination proceedings. In the instance of initiation of limitation or termination processes, the suspension may be extended beyond the 60 days and until such time as all steps in the limitation or termination procedures are exhausted. Procedures for suspension are as follows:

A. The designated HEAF official notifies the school or lender by certified mail, with return receipt requested, of HEAF's intent to suspend the participant from the GSL, SLS and PLUS programs, citing the consequences of that action and identifying the alleged violations on which the proposed action is based. The initially designated beginning date of suspension shall not be less than 20 days from the date the letter of intent is mailed.

B. The participant, subject to the suspension notice, may request a hearing before a presiding officer, and/or submit written material for consideration by the designated HEAF official, or voluntarily agree to correct the alleged violations. In the instance of voluntary correction, the process may be adjudged by the designated HEAF official as completed until and unless additional complaints or other information reinitiates action. If the participant submits written materials and/or requests a hearing within 15 days of the suspension notice being mailed, the designated suspension date will automatically be delayed until after a final determination is made through the provided due process.

C. If the participant does not request a hearing but submits written material, the designated HEAF official considers that material and notifies the participant that either the proposed suspension is dismissed or the suspension is effective as of a specified date. If suspension is upheld, the participant may still request a hearing and have the suspension deferred until hearing procedures are completed, if he/she makes the request for a hearing within 10 days of receiving notice of the suspension being upheld.

D. If, under any of the cited circumstances as set forth herein, the lender or school requests a hearing, the date of the hearing will be at least 15 days after the request is received.

1. A presiding officer will conduct the hearing, and a written record will be made.

2. The presiding officer will consider any written material presented before the hearing and all evidence presented at the hearing.

3. The presiding officer will make an initial decision to either uphold the suspension or to overturn it.

4. HEAF will review the initial decision and issue a final decision as supported by the presiding officer's recommendations and the evidence available.

5. If the final decision is to suspend the school or lender, a notice of such is promptly mailed by HEAF to the participant, and the suspension takes effect on the date that was originally set by the designated HEAF official or immediately upon the date of mailing of the final decision notice, whichever is later.

6. If the designated HEAF official begins a limitation or termination proceeding before the suspension period ends, the suspension period may be extended until the completion of that proceeding, including any appeal to the President of HEAF.

7. Limitation or Termination. A termination removes the eligibility of the lender or school to participate in the GSL, SLS and PLUS programs for an indefinite period of time. A limitation may place a restriction on the amount or number of loans or any other reasonable restrictive requirements or conditions for an indefinite period of time. Procedures for limitation or termination are as follows:

   A. The designated HEAF official notifies the school or lender by certified mail, with return receipt requested, of HEAF's intent to impose limitations or terminate participation in the GSL, SLS and PLUS programs, citing the particulars and consequences of the intended action and identifying the alleged violations on which the proposed action is based. The initially designated beginning date of limitation or termination shall not be less than 20 days from the date the letter of intent is mailed.

B. The participant, subject to the limitation or termination notice, may request a hearing before a presiding officer and/or submit written material for consideration by the designated HEAF official or voluntarily agree to correct alleged violations. In the instance of voluntary correction, the process may be adjudged as completed by the designated HEAF official until and unless additional complaints or other information reinitiates the action. If the participant submits written materials and/or requests a hearing within 15 days of the limitation or termination notice being mailed, the designated limitation or termination date will automatically be delayed until after a final determination is made through the provided due process.

C. If the participant does not request a hearing but submits written material, the designated HEAF official considers that material and notifies the participant that either the proposed limitation or termination is dismissed or the limitation or termination is effective as of a specified date. If the limitation or termination is upheld, the participant may still request a hearing and have the limitation or termination deferred until hearing proceedings are completed, if he/she makes the request for a hearing within 10 days of receiving notice of the limitation or termination being upheld.

D. If, under any of the cited conditions as set forth herein, the lender or school requests a hearing, the date of the hearing will be at least 15 days after the request is received.

1. A presiding officer will conduct the hearing and a written record will be made.

2. The presiding officer will consider any written material presented before the hearing and all evidence presented at the hearing.

3. The presiding officer will make an initial decision to either uphold the limitation or termination or overturn it. He may also make an initial decision to modify the nature of the initial finding, or place limitations on the participant, rather than terminating entirely from the program.

4. HEAF will review the initial decision and issue a final decision, as supported by the presiding officer's recommendations and the evidence available.

5. If the final decision is to limit or terminate a school or lender, a notice of such is promptly mailed by HEAF to the affected participant and the limitation or termination takes effect on the date that was originally set by the designated HEAF official or immediately upon the date of mailing of the final decision notice, whichever is later.

E. With the approval of the presiding officer and the consent of the designated HEAF official and the lender or school, any time schedule specified in this section may be shortened.

8. Appeal and Corrective Actions. Lenders and schools receiving a final decision of limitation or termination may appeal the final decision to the President of HEAF, but the final decision deadlines will stand pending the outcome of any such appeal. Corrective action may include required payment to HEAF or to any designated recipients of any funds that the lender or school improperly received, withheld, disbursed, or caused to be disbursed. If a final decision requires reimbursement or payment by the participant to HEAF, HEAF may offset these claims against any benefits due the participant.

9. Reinstatement After Termination. A terminated lender or school may file a request for reinstatement of eligibility only after 18 months have elapsed from the date of termination. Within 60 days of receiving the request, HEAF will act on the request. If HEAF denies or grants the request, subject to limitations, the lender or school will be granted an opportunity through a meeting, to show why all limitations should be removed.

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Senate Permanent Subcommittee
on Investigations
EXHIBIT # 27

SETTLEMENT AND RELEASE AGREEMENT

This Settlement and Release Agreement (this "Agreement") is entered into this 20th day of March, 1990, by and between James E. Gilleran, Superintendent of Banks of the State of California, as liquidator of First Independent Trust Company (the "Liquidator"), and the United States Department of Education (the "Department") with respect to the following facts:

RECITALS

A. First Independent Trust Company ("FITCO") originated over $1 billion in student loans through 1989. Those student loans were originated pursuant to the provisions of the Higher Education Act of 1965 (the "Act") and the regulations promulgated thereunder (the "Regulations"). Those student loans are called Guaranteed Student Loans ("GSLs").

B. Pursuant to §438(c) of the Act and the Regulations, the originator or holder of a GSL is required to pay an "origination fee" to the Department. The Department pays interest benefits and special allowance payments ("IB & SAP") to the holder of the GSL. The Department also reinsures the guarantee agencies which participate in the GSL program under §428 of the Act and which guarantee payment of principal and interest to the holders.

C. FITCO sold to purchasers in a secondary market (the "Holders") most of the GSLs it originated.

D. The GSLs that FITCO originated but did not sell to the Holders are now held in approximately 1,500 trust accounts (the "Trust Rate Accounts") for which FITCO was the trustee.

E. On May 19, 1989, the Superintendent of Banks of the State of California closed FITCO, and he is now the Liquidator in the liquidation (the "Liquidation") of FITCO under the provisions of the California Financial Code, certain events in which are subject to approval of the Superior Court of the State of California for the County of Sacramento (the "Superior Court") in Case No. 361659.

F. In October, 1989, the Department filed two claims in the Liquidation (the "Claims"). The Department asserts that the Claims have priority in the Liquidation under Federal law.

G. One of the Claims is for origination fees that the Department claims are owing from FITCO (the "Fees Claim"). The Fees Claim totals $4,422,509.75, but the Department now has evidence allegedly showing that the origination fees owing by FITCO may be larger and may exceed $5,500,000.

H. The Department's other Claim is for $1,129,740.00, arising from FITCO's alleged failure to process cancellations of GSLs in a timely manner, thereby causing the Department to pay to FITCO and to the Holders excess IB & SAP on loans that had been cancelled (the "Audit Claim"). The Audit Claim is based on an audit of FITCO conducted by the Department's Office of Inspector General, and the Department believes that it may have a greater claim upon completion of a more comprehensive audit of FITCO's processing of refunds on and cancellations of GSLs.

I. The Department has asserted that (1) it may seek payment of the Claims and other amounts from the Trust Rate Accounts or the settlors or beneficiaries thereof (the "Trust Rate Customers") and (2) if the origination fees are not paid, the GSLs are not eligible for reinsurance payments by the Department, and the Department may require the repayment of IB & SAP on all GSLs originated by FITCO since it first failed to pay origination fees that now remain unpaid.

J. The Liquidator disputes the amounts and priority of both of the Claims and all of the Department's assertions concerning its rights and remedies, including those made against the Trust Rate Accounts or the Trust Rate Customers.

K. Subject to approval by the Superior Court, the Department and the Liquidator, on behalf of the Liquidation and as the liquidator of the former trustee of the Trust Rate Accounts, desire to settle and resolve all of their disputes relating to the Claims.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, including the mutual promises recited herein, the parties hereto agree as follows:

1. Payment. The Liquidator shall pay to the Department the sum of $4,422,509.75 (the "Agreed Sum"), in settlement of the Claims and in consideration for the release in this Agreement. The Department understands that the Liquidator is seeking payments by the Holders of various portions of the Agreed Sum. The Department shall credit to the Agreed Sum any payment made at any time before the Closing (hereinafter defined) by any of the Holders on account of origination fees not previously paid by FITCO.

2. Withdrawal of the Claims. Effective as of the Closing, the Department hereby withdraws and agrees to forego any further payment on both of the Claims.

3. Release.

3.1 Scope of Release. Effective as of the Closing, the Department hereby forever releases and absolutely and forever discharges the Liquidator (including his predecessors, special deputies, counsel, employees, assistants, consultants and other agents and representatives), the Liquidation (but not including FITCO's present or former officers, directors, employees, attorneys or other agents or representatives), the Trust Rate Accounts, the Trust Rate Customers, and the Holders (the "Released Persons and Entities") from any and all civil and administrative claims, rights, obligations, liabilities, setoffs and demands of every character, nature and kind, which the Department has, owns or holds, arising from (a) any failure of FITCO to pay origination fees, (b) any deficiency of FITCO or the Liquidator in processing or failing to process cancellations of GSLs at any time, or (c) any previous billings by FITCO or the Liquidator for IB & SAP relating to loans affected by the alleged failure to pay orgination fees or the alleged failure to timely process cancellations (the "Released Claims").

3.2 Reserved Claims. It is acknowledged by the parties that, pursuant to the Act and the Regulations, there may exist grounds now unknown to the Department, and not of the type described in Section 3.1 of this Agreement, for cancellation of insurance by the Department of GSLs originated by FITCO. The Department agrees not to audit, explore or study further the alleged failure to pay origination fees or timely process cancellations, but, notwithstanding any other term or provision of this Agreement, this Agreement shall not constitute a waiver of deficiencies in the GSLs that are not of the type described in Section 3.1 of this Agreement and are hereafter discovered by the Department.

4. Warranty of Non-Assignment. The Department represents, warrants and agrees that none of the Released Claims has been sold, encumbered, subrogated, hypothecated or transferred, voluntarily or involuntarily.

5. Condition; Closing.

5.1 Condition. The obligations of the Liquidator, the Liquidation, the Trust Rate Accounts or the Trust Rate Customers to pay the Agreed Sum, and the other terms and provisions of this Agreement that are made effective as of the Closing, are subject to a final order of the Superior Court, not stayed pending appeal, approving this Agreement, and authorizing the Liquidator to perform it on behalf of the Liquidation and Trust Rate Accounts.

5.2 Closing. The closing (the "Closing") shall be held at a mutually agreeable time and location after Superior Court approval of this Agreement as described in Section 5.1.

5.3 Failure to Close. If the Closing does not occur within the later of (a) 120 days after the date of the execution of this Agreement, or (b) five business days after the final resolution of any appeal of the Superior Court order approving this Agreement, if closing was stayed pending appeal, then this Agreement shall be of no further force or effect, and the Department shall retain any and all of its rights to increase or assert the Claims and the Released Claims.

6. General Provisions.

6.1 No Reliance on Other Party. The parties hereto represent and declare that, in executing this Agreement, they have relied solely upon their own judgment, belief and knowledge, and upon the advice and recommendation of their own advisors and counsel concerning the nature, extent and duration of their rights and obligations deriving from this Agreement, or relating to the claims settled and released hereunder.

6.2 Choice of Law. This Agreement shall in all respects be interpreted, enforced and governed by and under the Act, the Regulations and the laws of the State of California, as California's laws are applied to instruments executed in California, by persons and concerning transactions solely within California.

6.3 Joint Drafting and Negotiation. This Agreement has been jointly negotiated and drafted. The language of this Agreement shall be construed as a whole according to its fair meaning and not strictly for or against either of the parties.

6.4 No Admission. This Agreement is intended to compromise disputed claims and causes of action, and nothing herein shall constitute or evidence the existence of any event, fact or thing, except as expressly agreed herein effective as of the Closing.

6.5 Successors and Assigns. The rights and obligations of the parties pursuant to this Agreement shall inure to and be binding upon their respective successors and assigns.

6.6 Third Party Beneficiaries. This Agreement is intended to benefit only the Department and the Released Persons and Entities. With these exceptions, there are no third party beneficiaries to this Agreement.

6.7 Integration. All agreements of the parties with respect to the subject matter hereof are contained in this Agreement, and this Agreement shall supersede all prior negotiations, agreements and understandings of the parties with respect thereto. This Agreement cannot be modified except by a written document duly executed by both parties.

6.8 Warranty of Signatories. Each person executing this Agreement on behalf of a party hereby individually represents and warrants to the other party that he or she has the authority to execute this Agreement on behalf of, and fully bind, such purported principal, subject to approval of the Superior Court.

6.9 Further Assurances. The parties hereby agree to execute such other documents and take such other actions as may reasonably be necessary to effectuate the purposes of this Agreement.

6.10 Liquidator's Capacity. This Agreement is entered into by the Liquidator of FITCO on behalf of the Liquidation and as liquidator of the former trustee of the Trust Rate Accounts; and this Agreement shall not create or evidence any duty or obligation of James E. Gilleran personally, of the Superintendent of Banks of the State of California, of the California State Banking Department or of the State of California.

UNITED STATES DEPARTMENT
OF EDUCATION

By
Title Deputy Assistant Secretary for
Student Financial Assistance

JAMES E. GILLERAN,
SUPERINTENDENT OF BANKS OF
THE STATE OF CALIFORNIA, as
Liquidator of First
Independent Trust Company

By James E. Gilleran
Title Superintendent of Banks

UNITED STATES DEPARTMENT OF EDUCATION

REGIONAL OFFICE OF INSPECTOR GENERAL
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Audit Control No. 09-90002
December 21, 1989

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 28

Dr. Leonard L. Haynes III
Assistant Secretary for
Postsecondary Education
ROB 3, Room 4082
7th & D Street SW
Washington DC 20202

Dear Dr. Haynes:

The purpose of this report is to provide you with the results of our REVIEW OF THE PROCEDURES USED BY MITCHELL SWEET AND ASSOCIATES TO SERVICE FEDERALLY GUARANTEED LOANS HELD BY THE BANK OF AMERICA AS TRUSTEE FOR THE CALIFORNIA STUDENT LOAN FINANCE CORPORATION.

INTRODUCTION

Background

Federal Student Loan Programs Title IV-B of the Higher Education Act of 1965, as amended, authorized the Stafford Student Loan (Stafford) program. The Stafford program, formerly the Guaranteed Student Loan program, makes low-interest insured loans available to students for attending institutions of postsecondary education. The Federal government subsidizes a portion of the interest on Stafford loans, thereby enabling lenders to obtain competitive interest rates on loans while providing students with loans at below-market rates. State guarantee or private nonprofit guarantee agencies insure loans made by lenders participating in the government loan programs. The Federal government reimburses the guarantee agencies for all or part of the insurance claims they pay to lenders.

The Higher Education Amendments of 1986 created the Supplemental Loans for Students (SLS) program. Under the SLS program, a graduate or professional student, or an independent undergraduate student, may borrow up to $4,000 per academic year, to a maximum outstanding debt of $20,000 in addition to loans obtained under the Stafford program.

Federal regulations require that lenders perform specified collection activities on all guaranteed student loans that have entered repayment status. These steps are necessary to maintain the loans' eligibility for insurance by a guarantee agency and reinsurance by the Federal government. The required actions include diligent attempts at phone contacts and increasingly forceful letters, generally every 30 days.

Mitchell Sweet and Associates Mitchell Sweet and Associates (MSA) is a privately owned student financial aid consultant and loan servicer. MSA services loans held by the Bank of America as trustee for the California Student Loan Financing Corporation. As of August 3, 1989, MSA was servicing a total of 76,771 loans in various stages in the loan cycle, with a total cumulative loan value of approximately $135 million. MSA has not received any new loans to be serviced since August 1988.

The Department of Education and the Higher Education Assistance Foundation (HEAF) conducted a joint review of MSA in July and August of 1988. The review concluded that MSA staff had engaged in the systematic falsification of loan collection activities since at least May 1988 through July 1988. The evidence collected during the review indicated that some MSA employees had entered fictitious phone calls and backdated missing letters in system records. The employees did this to conceal that required due diligence steps had not been performed. The omission of those steps could have resulted in a default claim being rejected. MSA asserted that, after the report of the joint review, it implemented various controls to prevent the problems from recurring.

Scope of Audit

The purpose of this audit was to determine whether MSA was currently performing due diligence on the Stafford and the SLS loans as required by the Federal regulations. Our review covered the period September 1, 1988 through August 3, 1989. Our review was designed to address those problems identified in previous periods which indicated that due diligence contacts had been falsified.

Our evaluation of loan servicing included a review of current due diligence policies and procedures. Specifically, we (1) reviewed the system for recording due diligence phone contacts or attempts to contact student borrowers who were behind in their scheduled payments, (2) determine whether due diligence telephone contacts were made as required, and (3) determined whether due diligence letters were being mailed out and in a timely manner. We randomly selected a total of 100 borrowers (representing 118 loans) for our evaluation during the period September 1, 1988 through August 3, 1989. During this time period 40,354 loans entered repayment, with a cumulative loan value of $93,854,445.

Our audit was performed in accordance with generally accepted government auditing standards appropriate to the limited scope audit described above. Our fieldwork was performed during the period July 24, 1989 to September 22, 1989 at MSA's offices in Tempe, Arizona.

Statement of Internal Controls

As part of our audit, we made a limited study and evaluation of internal controls to the extent considered necessary to evaluate the system, as required by generally accepted government auditing standards. The specific internal control category reviewed covered the due diligence in servicing the Stafford and SLS loans.

The management of MSA is responsible for establishing and maintaining internal control systems, including those used in administering student financial assistance programs. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. Internal control systems are intended to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with management's authorization;
- resources are safeguarded against waste, loss, and misuse;
- financial statements are prepared in accordance with generally accepted accounting principles;
- reliable data are obtained, maintained, and fairly disclosed in financial reports; and
- resources are used consistent with laws, regulations and policies.

Because of inherent limitations in any system of internal controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in this control category. However, our study and evaluation disclosed no condition that we believe to be a material weakness.

RESULTS OF AUDIT

Based on our review of selected controls employed by MSA and the results of our review of randomly selected borrowers, we concluded that the current system of internal controls was adequate for performing due diligence in accordance with Federal regulations on Stafford and SLS loans.

Before July 1988, MSA's system allowed telephone calls and attempted calls to be backdated. Therefore, MSA employees could alter records of those loans in which the required due diligence contacts had not been completed in order to prevent claims from being rejected. The Bank of America reviewed the period April through August 1988, to determine whether MSA had backdated calls. Bank of America's review indicated that there were approximately 900 telephone contacts dated in June that were not on the month-end June report, but which appeared on the July report. On July 29, 1988, MSA implemented a system change to exclude the date entry from the contact file transaction update. This change eliminated the ability to backdate entries. Our review of this system change indicated that it was working correctly.

MSA implemented a new automated phone dialing system in November 1988, called Voicelink. This system calls borrowers at the rate of 750 per hour, compared with the previous manual standard of 36 calls per hour (3 collectors). When the Voicelink system reaches a borrower, as soon as a collector is available, he or she takes the call and discusses the borrowers current loan status. This allows the collectors to concentrate on talking with borrowers instead of dialing phone numbers.

The Voicelink system continually makes calls. However, it slows down if all collectors are busy talking with borrowers. The Voicelink system generally operates on a four-week cycle each month, with each week devoted to working a particular group of borrowers in various stages of past due status.

The majority of calls by Voicelink are unsuccessful; that is no answer, line busy, telephone answering machines, etc. The Voicelink system generates a tape each month of all telephone numbers dialed, including a code to note the disposition of the calls. This data is then uploaded to MSA's contact file, which documents calls to individual borrowers. For the period November 1988 through July 1989, Voicelink accounted for approximately 72 percent of all contacts and attempted contacts.

Our review of the Voicelink system and the corresponding system to record calls on the borrower contact file indicated that the control procedures were adequate to ensure that calls were recorded properly.

Contacts with students can also originate through borrower call-ins, some of which result from previous Voicelink calls (i.e., leaving messages with others to have the borrower call in). During the period November 1988 through July 1989, borrower call-ins represented approximately 16 percent of the total contacts or attempted contacts during this time period. Controls used by MSA to ensure proper recording of these contacts included random audits by its Quality Control and Compliance (QCC) group. Each month, the QCC group selected a random day to listen in on conversations and records the type of responses from the borrowers. It then checked the borrowers' contact files to determine whether calls were recorded properly. Any discrepancies noted are discussed with the appropriate MSA officials and corrections made if necessary.

Calls are also made in the skip-tracing process. When a letter is returned because of a bad address, the information is entered on MSA's system. The system automatically prints letters to the borrower's references requesting his or her current address. The skip tracers call directory assistance and the borrower's references to obtain a new address or telephone number. MSA has a procedure to test whether all outgoing calls recorded as being made by collectors can be traced and verified to calls recorded by the Call Detail Recording (CDR) software system. Every call that is made from an MSA phone is recorded by the CDR system. A random sample of skip-tracing calls for a specific day are traced to information retrieved from the CDR system for that day.

Our review of MSA's system for recording and documenting due diligence letters which are sent to students who are behind in payments indicated that letters were mailed and copies were filed in the borrowers' files in a timely fashion. MSA has implemented a procedure to verify each month a randomly selected due-diligence mailing to ensure that all letters generated by the system are placed into envelopes and mailed.

The results of our review of 100 randomly-selected borrowers (representing 118 individual loans), indicated that supporting documentation was on file and required due-diligence was performed in accordance with Federal regulations.

We discussed the results of our review with the Vice President of the California Student Loan Finance Corporation, who agreed with the facts contained in this report and our conclusion.

OTHER MATTERS

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained is not subject to exemptions in the Act.

Please refer to the Audit Control Number A0990002 in all correspondence relating to this report.

Sincerely,

Sefton Boyars

SEFTON BOYARS
Regional Inspector General
for Audit

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Office of Inspector General

ED-OIG
Postsecondary Education Branch 1

General Operations Branch 2

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 29
September 13, 1990

Department of Education
Student Financial Assistance
Program Reviews

FISCAL YEAR	INSTITUTIONAL REVIEWS	LENDER REVIEWS	GUARANTEE AGENCY REVIEWS*
1981	1,058	909	10
1982	510	802	10
1983	648	773	10
1984	721	763	10
1985	763	675	10
1986	417	463	10
1987	372	222	8
1988	677	282	10
1989	788	519	13
1990 (estimate)	1,050	730	24
1991 (estimate)	1,050	926	24
1992 (estimate)	1,050	926	24

* From FY 1981-86, Guarantee Agency reviews were not tracked separately. These numbers are estimates.

OSFA Regional Staffing for Program Review

(a) FY	(b) Nonsup. IR	(c) Nonsup. LR	(d) Sup. IR	(e) Sup. LR	(f) Total
1981	55	36	10	*	101
1982	47	34	10	*	91
1983	49	32	10	*	91
1984	54	37	10	*	101
1985	56	39	10	*	105
1986	52	33	10	*	95
1987 ceiling	56	22	10	6	94
1987 on board	55	21	10	6	93
1988 ceiling	55	22	10	6	93
1988 on board	52	21	10	6	89
1989 ceiling	91	39	22	6	158
1989 on board	83	36	14	6	139
1990 ceiling	91	39	22	6	158
1990 on board	86	36	22	6	150

* Prior to the 1986-1987 reorganization, a single person supervised both institutional (school) review and lender/guarantee agency review in nearly all regions.

Legend:

(a) Fiscal Year
(b) Nonsupervisory Institutional Reviewers
(c) Nonsupervisory Lender Reviewers
(d) Supervisory Institutional Reviewers
(e) Supervisory Lender Reviewers
(f) Total - sum of (b) - (e)

JUL 31 1990

USA FUNDS
A Not-for-profit Corporation Serving Education

United Student Aid Funds, Inc.
8115 Knue Road
P.O. Box 50827
Indianapolis, Indiana 46250
(317) 849-6510

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 30-G

PROGRAM ASSESSMENT REPORT

Name of Servicer: United Education and Software

Address:
3050 Redhill Avenue
Costa Mesa, CA 92626

Date of Review: June 6 - 7, 1988

Names of Reviewers:
Ms. Debra Schweikert
Manager, Compliance Services
USA Funds

Ms. M. Susie Nickels
Compliance Specialist
USA Funds

Primary Officials Contacted:
Ms. Gretchen Staff
Vice President

Ms. Leita Elliott
Customer Services Director

Mr. Bill Star
National MIS Director

I. BACKGROUND

United Education and Software (U.E.S.) was founded in 1961. It is a publicly held corporation employing 2000 persons. The corporation has two divisions, a education group which owns and manages 33 private schools and a data systems and services area which handles loan servicing as part of its responsibilities.

U.E.S. currently services approximately 500,000 loans with a value of over one billion dollars. The Costa Mesa facility processes transactions on a 24-hour basis.

II. STATEMENT OF PROBLEM

In January, 1988 a problem in claim processing was detected by USA Funds' Claim Review Unit. None of the U.E.S. claims which were received evidenced an LRA submission. U.E.S. was phoned prior to the return of the claims; however, no explanation of the lack of LRA's was offered.

By the end of February, the number of rejected claims rose to over 1000, most of the claims being loans made under the AELP guarantee. At this point, another problem began to surface. A pattern emerged in the phone call records of four U.E.S. collectors. One of the collectors consistently recorded a promise to pay without giving any details about when the payment was expected or how much of a payment could be expected. Another collector recorded that a message was always left on the borrowers' answering machines. Another collector always got a wrong number. The final collector consistently listed that a message was left for the borrower to call U.E.S. The instances of these calls exceeded anything that could be expected by chance.

At this point, Woody Farber contacted Gretchen Staff at U.E.S. and Trent Nebeker of the California Student Loan Finance Corporation (since most of CSLFC's collateral is the paper serviced by U.E.S.). Woody explained our corcerns. Both Ms. Staff and Mr. Nebeker welcomed USA Funds to conduct a review to determine what problems existed.

A review was conducted June 6 - 7, 1988. By this time approximately 2,000 U.E.S. claims had been rejected. Seventy-one (71) files were selected for review conducted on-site at the U.E.S. facility in Costa Mesa.

III. REVIEW FINDINGS

1. There was a lack of evidence of LRA's in all files reviewed. However, it does appear that the lender was attempting to submit them, since "pre-claims assistance" notations were found on computer records of due diligence for all files reviewed.

   Upon further research, it appears that there was a communication problem between U.E.S. and USA Funds. U.E.S. was attempting to submit LRA's at 60 days on the delinquent accounts. However, USA Funds returned the LRA's due to there being no loan transfer record to U.E.S. on file at USA Funds. U.E.S. believes the LRA's were resubmitted, but has no records which could substantiate that this had been done. U.E.S. was able to produce two of the original reject letters from USA Funds.

   Resolution

   The problem appears to have been corrected. U.E.S. has gone to tape submission of LRA's and has not been experiencing the rejects of the past. However, this is a very recent occurrence (within the past two months), so there still may be claims arriving with no record of an LRA. It is not anticipated that this problem will remanifest itself in the future.

2. There was a problem with due diligence activities performed in all files examined. The following chart illustrates the non-compliance areas:

Federal Requirements	U.E.S. Procedures	Problem
30 Days Delinquent:		
2 written collection notices.	2 collection letters - one 10-day notice and one 30-day notice.	The 30-day notice in many cases was being generated on the 33rd day of delinquency.
31-60 Days Delinquent:		
3 telephone contact attempts at different time/different days; if unable to contact, at least 2 increasingly forceful collection letters must be sent.	3 telephone contact attempts made at different times and different date; if unable to contact, letter is sent on 45th day.	One letter is missing.
60-90 Days Delinquent:		
LRA submission.	Pre-Claims Assistance submitted.	No problem.
61-150 Days Delinquent:		
Telephone contact each 30 days; one collection letter each 30 days if unable to contact by phone.	Telephone attempts every 30 days, collection letters sent at 90 and 120 days if unable to contact.	Missing one letter.
150 Days Delinquent:		
Final demand letter to borrower requiring payment in full; letter must notify that default will be reported to all credit bureaus.	Final demand sent to borrower requesting payment in full; letter notifies the borrower that default will be reported to credit bureaus.	Final demand letter does not state that default will be reported to all credit bureaus.
180-270 Days Delinquent:		
Default claim submission	Default claim submission.	No problem.

In addition, a few specific problems were noted. Due to a computer "glitch" which occurred in October, 1987, no 10-day delinquency letters were sent. Also, until April, 1988, the servicer had inadequate personnel to perform the necessary phone due diligence; thus, phone call requirements were not met on any of the delinquent accounts examined.

Resolution

U.E.S. has agreed to insert the necessary letters which are missing from the current procedures in order to fall into compliance with Federal due diligence requirements. The Final Demand letter will be changed to read "all credit bureaus". Letters will be sent on the prescribed schedule. There is now adequate staffing to allow for performance of the required phone work.

3. The lender had been excessively capitalizing interest on accounts on which they receive late notification. USA Funds' policy during the time period covering these accounts allowed for capitalization of interest for only.30 days past the date of late notification. U.E.S. appeared to be capitalizing up to the first payment due date.

   Resolution

   U.E.S. was informed of the problem during the exit interview and was brought up to date on our new policy.

   A high number of claims had been rejected due to this reason. U.E.S. is familiar with the recent 75-day rule for establishing a first payment due date for borrowers on whom they have received late notification of a last date of attendance. The automated system will be programmed to not charge interest beyond that allowed by the federal guidelines

4. Phone due diligence was seemingly fabricated by four collectors at U.E.S. (Lewis, Cammarill, Plude and Valasque). The four individuals were dismissed from U.E.S. in August, 1987.

   Resolution

   At the time these incidents occurred, U.E.S. did not monitor individual collector activity.

   The servicer has now implemented a daily computer generated report detailing the activities of each collector and the type of comments logged on each account. This should eliminate the possibility of a reoccurrence of this problem.

IV. SUMMATION OF FINDINGS

This seems to be the case of a servicer who grew too fast and did not have sufficient controls in place to monitor the quality of activities it was conducting. Poor communication between the supervisors and upper management exacerbated the problem. Management was apparently not aware of the high number of claims which had been rejected or the problems with LRA submissions.

U.E.S. has expressed a willingness to do whatever it takes to be 100% in compliance with federal law, regulations and USA Funds' procedures.

Respectfully Submitted,

Debra L. Schweikert
Manager,
Compliance Services

d/pc/125

USA FUNDS
A Not-for-profit Corporation Serving Education

United Student Aid Funds, Inc.
8115 Knue Road
P.O. Box 50827
Indianapolis, Indiana 46250
(317) 849-6510

July 27, 1988

Mr. Aaron Cohen, President
United Education and Software
3050 Redhill Avenue
Costa Mesa, California 92626

Dear Mr. Cohen:

This letter is written in response to recent correspondence relating to the program assessment review conducted by USA Funds' Compliance Services staff at the U.E.S. facility in Costa Mesa, California, and to certain questions which have been raised since the completion of that review relating to claims submitted by U.E.S. For ease of reference, a copy of USA Funds' Program Report is enclosed with this letter.

As the enclosed report indicates, several serious due diligence deficiencies were noted in the course of our review. As we discussed in the exit interview, the most notable of these deficiencies involve four collectors (Valasque, Plude, Lewis and Camarille), who appear to have fabricated telephone due diligence on numerous claims which have been submitted to USA Funds.

In view of the fact that USA Funds has been compelled to cancel its' guarantee on over 2,000 loans serviced by U.E.S., with more being filed and rejected each week, the importance of the situation cannot be overstated.

For claims on which these collectors did not play a role, the guarantees may be reinstated in accordance with standard cure procedures outlined in the enclosed copy of USA Funds' March, 1988, Operations Bulletin. In those cases where all types of collection efforts were undertaken, U.E.S. may cure the deficiency by obtaining a signed repayment schedule or one full payment from the borrower.

Accounts which were handled by these four collectors cannot be cured in this manner. It is our understanding that these loans are not eligible for federal reinsurance. Therefore, USA Funds is unable to purchase any of these or similarly situated loans until U.E.S. provides written confirmation from the U.S. Department of Education that reinsurance will be paid.

I hope this clarifies the disposition of these claims. Should you have further questions, please call Ms. Deborah Gossman, Director of Claim Review, or myself.

Sincerely,

Debra L. Schweikert
Manager, Compliance Services

d/pc/139

USA FUNDS
A Not-for-profit Corporation Serving Education

United Student Aid Funds, Inc.
8085 Knue Road
P.O. Box 50827
Indianapolis, Indiana 46250
(317) 849-6510

February 10, 1988

United Education & Software
Student Loan Center
Attn: Student Loan Collections
P.O. Box 19719
Irvine, CA 92713

Re: Due Diligence Letters

Dear Collection Representative:

USA Funds has received default claims submitted by your institution which contain due diligence letters which are not in compliance with the Federal Regulations for accounts which became delinquent on or after March 10, 1987.

According to the Federal Regulations 34CFR 682.411, the due diligence letters which are sent between 31 and 60 days of delinquency must specify that, "if the delinquency is not cured, the loan will be assigned to the guarantee agency, which in turn will report the default to a credit bureau, thereby damaging the borrower's credit rating, and may bring suit against the borrower to compel repayment of the loan".

In addition, the Final Demand letter must require repayment of the loan in full, notify the borrower that a default will be reported to all national credit bureaus, and allow the borrower at least 30 days to respond.

Please make the necessary corrections in order to be in compliance with the Federal Regulations.

If I may be of further assistance, please do not hesitate to contact me.

Sincerely,

Deborah S. Gossman

Deborah S. Gossman
Director, Claim Management

TPD12311

Student Loan Servicing Center

UES

3050 Redhill Avenue
Costa Mesa, California 92626
(714) 979-8800

United
Education &
Software

Deb-
FYI
Deb Goosman

March 7, 1988

United Student Aid Funds, Inc.
8085 Knue Road
P.O. Box 50827
Indianapolis, IN 46250

RE: Due Diligence Letters

Dear Ms. Goosman,

attached

I am in receipt of your letter, dated February 10, 1988, in which the terminology of our 30 - 60 day letters requires specific changes to comply with Federal Regulations 34CFR 682.411.

At present we are stocked aptly with these particular forms, and would respectfully request that we be allowed to utilize the stock on hand prior to complience to this particular due diligence statement, with the intention of changing the format as the stock depletes. The Final Demand letter is in the same circumstance. Arangements are underway at present to make the necessary corrections.

If there are any concerns as to the nature of this letter, please do not hesitate to contact me.

Sincerely,

Gary Barragan

Gary Barragan
Manager - UES

USA FUNDS
A Not-for-profit Corporation Serving Education

United Student Aid Funds, Inc.
8115 Knue Road
P.O. Box 50827
Indianapolis, Indiana 46250
(317) 849-6510

March 18, 1988

Ms. Gretchen Staff
Vice President
United Education & Software
Suite 301
1805 E. Dyer Rd.
Santa Ana, CA 92705

Dear Gretchen:

As we discussed on the telephone, here is the letter which was sent to Gary Barragan concerning the due diligence letters, as well as his response. I have also attached a copy of the letter sent in mid-February by our systems department concerning the pre-claim assistance magnetic tape reporting.

To reiterate the concerns I expressed to you on the telephone, the following issues need to be addressed:

1. We have seen a larger than normal number of claims denied or returned to UES. The numbers I have available are:

	Denied	Returned
December	22	51
January	590	251
February	971	324
March (through 3/18)	44	

During this time period we have purchased approximately 35 claims.

2. Certain collectors seem to be experiencing the same problem with each attempted contact. For example;

   - G. Lewis always speaks with the borrower and gets a promise to pay.
   - C. Valasque always gets an answering machine.
   - J. Plude always gets a wrong number.
   - L. Camarill always leaves a message to call or gets a promise to pay.

3. The time calls are placed raises some serious concerns. While I understand your explanation that the "ITC" message uses "military" time (24 hour clock), we have identified many instances where messages entered by the collectors use the 24 hour clock. Thus, the calls at 2:42 can't be explained as easily as we thought (see attached Collection History for Kae L. Helman).

4. The discussion with Gary relative to pre-claim requests not being filed and thus resulting in denied claims occurred approximately three weeks ago.

Gretchen, these items raise serious concerns as to how both USA Funds and AELP's portfolio's are being serviced. For this reason, we will be conducting a compliance review of Bank of America - Trustee under the lender code 801178. This will cover the accounts serviced by UES for Bank of America.

The earliest I can free up a Compliance Specialist to complete the review will be the beginning of June. Debra Schweikert, Manager, Compliance Services, will be sending you a letter shortly outlining the dates and the information required from UES.

After you have had a chance to review the enclosed materials with your staff, please contact me so we may discuss it.

Sincerely,

Elwood G. Farber
Senior Vice President
Guarantor Services

EGF/kb

enclosures

cc: Debra Schweikert
Trent Nebeker, CSLFC

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 30-H

REPORT ON REVIEW OF

SERVICING OF LOANS BY UNITED EDUCATION AND SOFTWARE, SERVICER FOR LOANS HELD BY THE BANK OF AMERICA AS TRUSTEE FOR THE CALIFORNIA STUDENT LOAN FINANCE CORPORATION

Review Performed at
UNITED EDUCATION AND SOFTWARE
3050 Redhill Road
Costa Mesa, California

JOINT REVIEW BY

U. S. DEPARTMENT OF EDUCATION
HIGHER EDUCATION ASSISTANCE FOUNDATION
CALIFORNIA STUDENT AID COMMISSION

AUGUST 25, 1988

Servicing of Loans Held by the Bank of America as Trustee for California Student Loan Finance Corporation

INTRODUCTION

The purpose of this review was to examine the servicing of loans held by the Bank of America as trustee for the California Student Loan Finance Corporation (CSLFC), a secondary market for student loans, to determine compliance with Federal statutes and regulations governing the Robert T. Stafford Loan Program, (formerly the Guaranteed Student Loan Program). The review was made at CSLFC's primary loan servicer, United Education and Software (UES). The Bank of America acts as trustee for CSLFC and is the lender of record for the loans.

The review was conducted on August 1 through 5, 1988, by a joint team from the Department of Education (ED), the California Student Aid Commission (CSAC) and the Higher Education Assistance Foundation (HEAF). The members of the review team were:

Jack Keefe, Region IX, Department of Education
Robert Chin, Region IX, Department of Education
Robert Armstrong, Central Office, Department of Education
Wendie Doyle, Higher Education Assistance Foundation
Sean Dougherty, Higher Education Assistance Foundation
Sydney Jameson, California Student Aid Commission

SCOPE OF REVIEW

Although the review was thorough and extensive loan servicing problems were found, the review cannot be assumed to be all inclusive. Therefore, the absence of statements in this report regarding specific practices and procedures should not be construed as acceptance, approval, or endorsement of those practices and procedures.

The review included an analysis of a sample of 178 loan accounts guaranteed by CSAC (103) and HEAF (75). The following sections give a brief description of the findings found by the review team. Attachment A contains a more detailed description of problems found on specific loan accounts by HEAF. Attachment B contains the results of the file review performed by CSAC.

This report does not contain specific corrective actions which must be taken by UES or CSLFC. However, the findings in this report will serve as the basis for discussion with appropriate officials concerning necessary corrective actions.

SUMMARY OF FINDINGS

The review team found serious loan servicing deficiencies and due diligence violations in nearly all aspects of UES' loan servicing operations. Among the most serious problems found by the review team are:

- Failure to perform due diligence, i.e., failure to send delinquency letters, make telephone contacts, undertake skip-tracing, etc. In one sample of files, 92 percent (78 of 85 CSAC files) contained some type of due diligence violation.

- Failure to process over 100,000 student status change reports, deferments and forebearances.

- Inaccurate collection histories which included telephone contacts which were not made and demand letters which were not sent.

- Submission of claims to guarantors with inaccurate collection histories and copies of letters not sent.

- Erroneous interest and special allowance billings, including billings for denied claims and claims past the timely filing deadline.

- Unacceptable record-keeping practices--inability to locate 11 percent of loan files (20 of 178), unreadable and unusable microfilm records and huge backlogs of filing.

- Failure to convert loans into repayment and send disclosure statements and coupons on a timely basis.

- Delays and errors in posting payments to borrower accounts.

- Charging of late fees when payments were not late.

- Insufficient staffing to perform collection activities and handle the numerous borrower complaints.

More details of the review team's findings are discussed in the following sections.

FINDINGS

1. FRAGMENTATION OF LOAN ACCOUNTS

When loans are initially converted onto the UES servicing system, they are assigned a specific portfolio number which corresponds to a particular trust indenture of the California Student Loan Finance Corporation (CSLFC). When a borrower has more than one loan being serviced by UES, the loans are very likely assigned to separate portfolios and serviced separately. The borrowers are billed separately and must send in separate checks to cover the loan payments.

To compound the problem, UES also was splitting disbursements of the same loan into separate portfolios. This fragmentation of accounts resulted in a number of unusual problems. Separate disbursements of the same loan would have different grace period ending dates. Collection activity on the same loan was not co-ordinated. This practice causes record-keeping problems for UES and significant confusion on the part of borrowers.

2. CONVERSION TO REPAYMENT

Lenders are required to promptly contact the borrower and establish terms of repayment after they learn that the borrower is no longer enrolled at a participating school on at least a half-time basis. During our file review, we noted borrowers who were put into repayment too early, too late or not at all. We also noted instances where the anticipated graduation date was not changed when school refunds were received. A major contributing factor to these improper conversions was that UES failed to react to enrollment verification reports issued by guarantors or to student status change notices from schools. This problem is discussed further in section 6 below.

3. REPAYMENT DISCLOSURES AND COUPONS

The UES system is haphazard at best in generating repayment disclosures and/or coupons to borrowers entering repayment. During the review, several file cabinets in the warehouse were found to contain original repayment disclosures which had first payment due dates ranging from January 1, 1988 to September 1, 1988. In many cases, a repayment disclosure was generated but no coupons were sent. In other instances, coupons were sent, but a repayment disclosure was not. Coupons and disclosures were sometimes sent after the first payment due date had passed. Instances were also noted of borrowers being sent delinquency notices when neither coupons nor a repayment disclosure had ever been sent. We also noted erroneous disclosures and repayment schedules. For example, UES would use the initial principal balance for borrowers whose accounts received a refund several months earlier.

4. PAYMENT APPLICATIONS

Five problems were noted in the application of borrower payments to loan accounts. First, a payment made by a delinquent borrower who was more than one month in arrears would only advance the due date by one month even if the borrower paid the entire delinquent amount. For example, a borrower who is three months past due in August of 1988, would be $150.00 in arrears. If that borrower makes a $200.00 payment by September 1, the borrower is current. The UES system however, would show that borrower's next due date as July 1, 1988, and the borrower would continue to receive delinquency letters. This results in endless borrower complaints as borrowers are unable to understand why they continue to receive letters and phone calls when they have brought themselves current. In order to advance the due date on a particular account in this situation, a request is sent to the accounting department which must then reapply the payments manually. This is not done unless the borrower brings it to the attention of UES.

A second problem noted in at least one case, was the application of the entire payment amount to interest rather than to interest and principal. After making several monthly payments the borrower inquired as to why the principal balance had not been reduced and was told that the payments had all been applied to interest. UES officials were unable at the time of the review to explain how that could have occurred.

A third problem with payment applications is the likelihood of applying payment or refunds to the wrong borrower account as a result of the borrower having several accounts with UES under different portfolio numbers, as mentioned above. We noted many borrower complaints due either to misapplication of payments or to UES' inability to account for a payment when a check had been cashed by UES but not applied to the borrower's balance.

A fourth concern is the timeliness with which payments are applied. The review team received conflicting statements from UES employees. While the Accounting Department maintained that payments were applied within 24 hours of receipt, other employees stated that it was common knowledge that accounting was always behind and easily could take several days for a payment to be applied to a borrower's account.

A final problem, noted during a visit by HEAF in June, is that UES routinely sent payments back to the borrower when the account had been sent to claim or was more than 30 days delinquent. Payments sufficient to bring borrowers back to early stages of delinquency were simply mailed back to the borrower rather than applied to the accounts or forwarded to the guarantor.

5. LATE CHARGES

Our sample of files contained several accounts where UES deducted $2.50 from the borrower's payment as a late charge when the borrower was making timely payments. This is in direct violation of 34 CFR Section 682.202 which allows late charges only after the borrower is ten days past due. While some correspondence was seen from borrowers which questioned why they were being charged late fees, it is likely that most borrowers would never find out that those amounts had been deducted from their payments.

6. PROCESSING OF DEFERMENTS, FOREBEARANCES AND STUDENT STATUS CHANGES

UES has acknowledged that, since October of 1987, its system has been incapable of processing changes to the status of the borrower. Although the system could accept the change, it apparently caused other problems to the loan account which then had to be manually corrected. Because of this system problem, UES ceased processing deferments, forbearances or student status changes to the borrowers' accounts. This resulted in several serious problems:

- o Borrowers were not converted to repayment in a timely manner, resulting in overbillings of interest and a higher percentage of skips and defaults.
- o Students were not receiving deferments to which they were entitled nor were they receiving forbearance agreements which had been discussed by telephone.
- o Borrowers who had submitted completed deferment forms continued to receive due diligence notices.
- o Borrowers often submitted two or three deferment or forbearance forms, all the while being told that it would be processed in a couple of weeks.

When HEAF visited UES in June of 1988, the unprocessed forms and letters were located in boxes in various locations around the building. Those forms have now been filed in the warehouse and most have been entered in summary detail into a computerized "hold list" which identifies the various forms and the date UES received them. A small sample of forms randomly taken from the warehouse, revealed that some, but not all, were included on the list. The review team estimated that the hold list contained items affecting approximately 100,000 accounts.

The failure to process deferment or forbearance forms has the potential to cause serious damage to individual borrowers. Borrowers entitled to deferments who are mistakenly put into default are subjected to all of the consequences associated with defaulting on a student loan which are quite severe. A borrower who is wrongfully defaulted may well have legal recourse against any entity, such as ED or a guarantor, which attempts further collection activity or wrongfully reports the borrower's status to a credit bureau. Loans which should have been converted to repayment continue to accrue federal subsidies and result in erroneous billings for interest and special allowance. Also, students entitled to deferments are being charged interest for periods of time when interest should be paid on their behalf.

At the present time, the UES system is still incapable of processing deferments or student status changes to the borrowers' accounts. Because of the sheer magnitude of the status changes that are not processed, coupled with UES' continuing inability to process status changes, there is serious doubt as to whether these loans can ever be reconstructed properly.

7. DUE DILIGENCE--LETTERS

There are three major problems with the letters generated by UES to comply with the due diligence requirements. First, based on borrower payment histories, delinquency letters appear to be sent in a random fashion. Sometimes no letters were sent to delinquent borrowers. Other borrowers would receive two or three of the same letter or a fourth or fifth delinquency letter without having received any of the prior letters.

A second problem is that there is some doubt as to whether the letters noted in the payment histories were actually sent to the borrowers. The review team compared the number of borrowers in delinquency versus the numbers of pieces of mail that were recorded as being sent from the mailroom. In many instances, insufficient numbers of delinquent mail were being sent by UES.

The third problem is that the standard letter series generated by UES does not meet the section 411 diligence requirements. Until very recently UES did not have a letter to be sent during the 121 to 150 day delinquency period. In addition, the language in some letters is deficient.

8. DUE DILIGENCE--TELEPHONE CONTACTS

Two major problems were noted with the telephone contacts that formed a part of the due diligence performed by UES. First, it was very clear from the review sample that minimal, if any, attempts to contact the borrower are made. Files would indicate no phone attempts at all or gaps of several months in the phone attempts that were made. In no case did the phone due diligence meet the requirements of 34 CFR 682.411.

[illegible] phone attempts were made by UES' automated calling system, a very common entry was "patron hung up on the hold". This indicates that a borrower was called by a machine, placed on hold by a machine when someone answered, and a collector was unable to come on the line to speak with that person prior to he or she hanging up. The review team was informed that the average length of time that a borrower would wait on hold prior to a collector coming on the line was anywhere from three to eleven minutes depending on the experience of the collectors working those particular calls.

A second and more significant finding is that many of the phone attempts documented in the borrowers' collection histories could not be substantiated by telephone company records of calls placed by UES. For example, borrowers' collection histories indicated that hundreds of calls were made on August 5, 1987 by four employees of UES. The time recorded by the computer system indicates that these calls were placed at all hours of the day and night. The four persons making the calls each had the same result with each call. For example, one collector always reached a bad number while a second collector always left a message to call.

The review team has received five different explanations for these particular phone calls from different individuals:

1. Leita Elliot--Since the computer records indicate that the telephone calls were made, they were, in fact, placed.

2. Trent Nebeker--UES and CSLFC officials became aware of four employees "plugging" phone calls last Fall and fired these employees.

3. Aaron Cohen--Those phone calls were uncovered during a USAF audit this Spring and those employees were then fired.

4. Aaron Cohen--Those employees were part of a drug ring and were fired for that reason.

5. Aaron Cohen--The entries in the collection history were actually the result of "testing" the new phone system, and it was never thought that they would appear in the computer-generated collection history.

In checking a random sample of the phone calls which were listed in borrower histories that were part of the review sample, only about one-half of the calls could be substantiated by a telephone company bill.

BEST COPY AVAILABLE

9. SKIP TRACING

One of the first indications of a major problem at UES was the significant number of borrowers who complained to HEAF and CSAC that they had never received any mail from UES. These borrowers contacted by the guarantor after a default claim had been paid were completely unaware that their loans were being serviced by UES and that they had not only entered repayment but were now in default.

One of the main reasons for this was the fact that letters to the borrowers were generated by the UES system containing the name of the postal station for a particular zip code rather than the name of the city in which the borrower lived. This resulted in mail being directed to such towns as Petworth, DC; Fruitvale, CA; Radio City, NY; and Bacon, IN. Letters addressed in such a manner were not likely to reach the borrower and resulted in significant amounts of returned mail to UES.

For several months UES did nothing with the returned mail and failed to initiate any skip tracing activities. At some point in time, UES began entering the fact that mail was returned on to the borrowers' histories but again, undertook no skip tracing activities. UES would file a claim with the guarantor indicating that the borrower was not a skip, even when UES' system showed the borrower was a skip (presumably due to the entry of return mail). UES officials attributed this to a "system glitch".

Use of the wrong borrower address has led to several other problems in servicing the accounts. Borrowers who requested deferment or forbearance forms would never actually receive such forms. When the borrower called a second or third time, they would be told that the forms had been sent.

After claims were paid, guarantors would receive returned mail on addresses which UES had sent up to eight delinquency letters without receiving returned mail. Calls for directory assistance on some accounts are now frustrated because UES provided only the borrower's postal station rather than city.

10. FINAL DEMAND LETTERS

According to records kept by the UES mailroom, final demand letters were mailed only in the months of April through September of 1987, and in January and February of 1988. Letters for these months appear to have gone out as much as one month late. UES officials have now acknowledged that for the remaining months final demand letters were not mailed to the borrowers. Even though the letters were not sent to the borrowers, the payment history generated by the computer would indicate that a final demand letter had been sent and a copy of a final demand letter would be submitted to the guarantee agency with each claim filing.

11. CLAIMS PROCESSING

The claims processing unit at UES is responsible for readying all claim files for shipment to guarantee agencies. A listing of accounts more than 180 days delinquent is generated by the computer system and sent to the claims unit. The file room is directed to pull the borrower's file, and the borrower payment histories and collection histories are also generated. The claims processing unit then reviews those materials and packages a claim.

At the time a claim file is put together, a repayment disclosure and final demand letter are inserted in the file shipped to the guarantee agency. The repayment disclosure and final demand letter are "regenerated" notices that are delivered from the computer room. They are not actual copies of the letter that were supposedly sent to the borrower. A claim file will contain a repayment disclosure or final demand letter even when the computer generated collection history would indicate that such a document never was generated. Final demand letters were included in claims files when, in actuality, the letter did not get mailed. The guarantee agencies were not informed that those documents were not copies of the original documents but were simply regenerated at the time of claim filing.

12. CUSTOMER SERVICE

It quickly became apparent to the review team that UES customers were not receiving an adequate level of service. At least until the very recent past, borrower correspondence went largely unanswered. Many complaints have been received regarding the near impossibility of reaching UES by telephone. Borrowers routinely get a busy signal or at best are put on hold. When borrowers are put on hold, there is not even an initial recording which announces that the borrower has reach UES or informs the borrower that he is on hold. The telephone system and staffing level is simply not adequate to handle a portfolio as large as UES' let alone respond to the tremendous number of complaints caused by UES' other servicing inadequacies.

13. RECORD RETENTION

Lenders are required to keep complete and accurate records on each loan. The review team requested 178 files for review but 20 of those files (or 11 percent) could not be located. UES explained that although claim files were microfilmed prior to being sent to the guarantors, there was a significant problem with the quality of the microfilm. Since the quality of the microfilm was not checked prior to sending the claims, a substantial number of rolls of film are partially or totally unreadable.

A second problem is that borrower files do not contain all relevant documents such as deferments, forbearances, or borrower correspondence. While these items are supposedly microfilmed, they are not presently retrievable due to the lack of an indexing system for the microfilm.

The third major problem noted was the tremendous backlog of filing. Boxes of unfiled material were located in the file room. The warehouse contained hundreds of file drawers of file material waiting to be filed dating back to 1985.

14. UES WAREHOUSE

When HEAF visited UES in June of 1988, it was discovered that the warehouse area of UES contained well over 100 boxes of various documents. A large number of boxes contained returned mail which contained everything from coupon books to delinquency notices to promissory notes marked paid in full. Other boxes in an open area next to an open door contained several hundred rejected claims returned by the guarantors which contained the original collateral for these accounts. Other boxes contained thousands of unprocessed deferment forms, forbearance forms, and student status change notifications.

By the time the review team returned to UES in August, the boxes had been removed from the warehouse. Many rows of filing cabinets had also been added. The review team was told that the boxes of returned mail were being stored offsite. Upon examining the contents of the new files drawers, it became apparent that much of the contents of the boxes were simply moved to the file drawers and in some cases, the boxes were placed in the file drawers.

15. ERRONEOUS BILLINGS OF INTEREST AND SPECIAL ALLOWANCE

Although the extent of overbilling of interest and special allowance was not quantified, UES' failure to process hundreds of thousands of student status reports, deferments and forebearances obviously affects the accuracy of UES billings for interest and special allowance. UES was continuing to bill special allowance for over 5,000 denied claims. UES was also billing special allowance on accounts past the timely filing deadline that had no collection activity since mid-1987.

We noted several errors in the system records, such as duplicate loan records and incorrect principal balances, which likely resulted in overbilling of interest. In one instance, a $2,500 loan was recorded as $25,000. It was not until one year later that the loan amount was "corrected" by the posting of a $22,500 payment.

Because many accounts already have multiple due diligence violations, significant overbilling of special allowance may have already occurred. Extensive reconstruction of accounts will be necessary to correct prior billings.

CONCLUSION

Because of the seriousness and magnitude of the deficiencies found in UES' loan servicing operation, the review team believes the ability of UES to service loans in accordance with Federal regulations is seriously in doubt. Errors, ommissions, and processing deficiencies in UES' system are so pervasive that UES' system records cannot be relied upon to support either claims or interest and special allowance billings. The review team is especially concerned about collection histories which show questionable telephone contacts and letters which UES admits were not sent. The review team believes that extensive reconstruction on a loan by loan basis is needed before any reliance can be placed on UES records.

UES' inability to service loans properly has caused immeasurable hardship to hundreds of thousands of borrowers. Many of these borrowers are now identified as defaulters and have lost future student aid privileges because UES failed to make reasonable attempts to contact the borrower and, in some cases, to even notify the borrower that payments were due and should be sent to UES.

The review team is also concerned that UES' problems were not identified and corrected at an early date. The California Student Loan Finance Corporation and the Bank of America should have ensured that there was effective oversight of the servicing of this large portfolio. Early detection and correction could have made most, if not all, of the current problems moot.

UES' mismanagement of the loan portfolio has already cost the guarantors and the U. S. Government millions of dollars. Immediate corrective action is needed to prevent the loss of additional sums.

STATE OF CALIFORNIA
GEORGE DEUKMEJIAN, Governor
CALIFORNIA STUDENT AID COMMISSION
P.O. BOX 942845 (916) 323-0435
SACRAMENTO, CA 94245-0845

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 32-D

April 14, 1989

Deno Evangelista
President
First Independent Trust Company
5325 Engle Road
Carmichael, CA 95608

RE: Lender Compliance Review: C90828374, C90829977 and C90828411

Dear Mr. Evangelista:

The results of the recent compliance review of your institution's participation in the California Student Aid Commission's programs are enclosed. This report is a compilation of the findings that were observed during the field review.

Some documentation was submitted to the Commission on April 11, 1989 in response to documentation requested during the on-site visit. The documentation did not alter materially the findings of the review. Reference to these materials is found in the body of the report with the pertinent issue involved.

Because of the seriousness of the issues presented in this report, the audit findings have been referred to the California Loan Program Administration with a recommendation for an action that will affect your institution's further participation in the loan programs.

The majority of the items reported under Major Review Findings and Concerns are continuing or reoccurring issues. Therefore, First Independent Trust Company (FITCO) must take immediate steps to correct and/or resolve those issues within 30 days of FITCO's receipt of this letter and attached report. FITCO is to respond to all other items in the report within 60 days of receipt of this letter.

The following specific actions must be taken by FITCO within the 30 day period:

1. Submit to the Commission a check for $4,422,509.75 for origination fees owed the USDE. This includes $3,018,443.28 for ID.#828374 and $1,404,066.47 for ID.#829977. The USDE Debit Letter and any necessary documentation that normally is mailed with origination fee payments by FITCO is to accompany the check.

2. File the quarterly Form 799 reports for 9/30/88 and 12/31/88 for lender ID. #828374 and ID.#829977.

   The resulting sums that will be billed in forthcoming Debit Letters as a result of FITCO's submission of the 9/30 and 12/31/88 Form 799's are to be paid in full to USDE within 30 days of receipt of said Debit Letters. Simultaneously, proof of payment must be submitted to the Commission.

3. Resolve the issues raised in section B of the report pertaining to reconciliation of Form 799's and supply any requested documentation.

4. Provide evidence that all identified schools have been billed and have paid for use of the ARIES computers since 7/1/87.

R-F

5. Provide evidence that all monies in the refund account have been forwarded to the current holders of all affected borrower accounts. Refunds received within the current 30-day period are to be the only ones remaining in the account.

   Proof of payment must include copies of checks and a list of the refunds forwarded which includes the borrower's name, social security number, date refund received by FITCO and refund amount.

6. The refund documentation is to also show that the $684,207.35 in September 1988 refunds received by FITCO has been forwarded to the current holders. Refer to #5 above for required documentation to be submitted to the Commission.

7. Provide documentation that the 15 remaining borrowers of the FITCO serviced loans and the 2458 borrowers of UES originated loans have had the excess .5% origination fee credited to their account. Also, answer the question regarding the discrepancy in the outstanding loans originated at 5.5% (page 18 of the report). The documentation to be submitted is a copy of the adjustment made to each borrower's account.

Although the review covered a broad scope, absence of negative comments concerning First Independent Trust's practices and procedures should not be construed as acceptance or approval of these areas.

Sincerely,

Rosemary Phillips
Supervisor, Lender Compliance
Audits - Investigations Unit

RP:SPJ:kt

Enclosures

cc: U.S. Department of Education
Lender and State Agency Review Branch

WARNING! ADD PAGE 42 AND PAGE 34A & B. THEY ARE PAGE 42.RE9 AND RESPONSE.86 ON THIS DISK.

First Independent Trust Company
5325 Engle Road
Carmichael, CA 95608

Dates of Review: February 27-March 24, 1989

I. Persons Contacted

David Patterson, Senior Vice President
Michael Ocenosak, Chief Financial Officer

II. Background

According to California Student Aid Commission (Commission) records as of March 1989, First Independent Trust Company's (FITCO) California Stafford Loan portfolio consisted of approximately 40,993 loans outstanding, with a total loan volume of $106,344,625 for lender I.D. #828374. FITCO's Supplemental Loans for Students (SLS) and Parent Loans for Undergraduate Students (PLUS) under lender I.D. #828411 consisted of approximately 9300 loans outstanding, with a total loan volume of $26,417,314. The lender uses I.D. #829977 to report loans originated on behalf of FITCO by United Education and Software (UES). Commission records as of March 1989 reflect for lender I.D.#829977 that the Stafford Loan portfolio consisted of approximately 9100 loans outstanding, with a total loan volume of $23,582,425. The SLS/PLUS loan portfolio originated under the same lender I.D. number according to Commission records reflects an outstanding balance of approximately 7300 loans outstanding with a total loan volume of $20,504,801. As of February 1989 the Stafford loan default rate for FITCO, as original lender, for I.D. #828374 and #829977 was 13.5% and 13.66% respectively. These rates do not include sold UES serviced claims that have not been submitted or paid due to UES servicing problems. The 2/89 SLS/PLUS default rates for FITCO, as original lender, for I.D.#828411 and I.D.#829977 are 12.58% and 0.01% respectively.

FITCO normally makes the first disbursement, then sells the loan to a secondary market. The second disbursement is then made and sold to the secondary market who purchased the first disbursement and promissory note. The normal turnaround time from first disbursement to sale has been a relatively short period of time. The lender in the past has not usually held and serviced loans. As can be seen from the delinquency chart below, few loans are currently being serviced by FITCO. The majority of the standard review sample was comprised of loans originated but sold prior to the on-site visit. The breakdown of the review sample shows that only a small number of files still held and serviced by FITCO are in repayment. Additional borrowers were tracked in the process of determining the lender's timeliness of handling refunds and cancellations.

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Information supplied at the time of the audit by the lender reflected the following delinquency pattern:

Delinquency Status as of 1/31/89 for FITCO serviced loans:

	# of Loans*	$ of Loans
30-60 Days	6	10,032.74
61-150 Days	4	6,955.84
151-180 Days	-0-	-0-
181-210 Days	-0-	-0-
Over 210 Days	-0-	-0-
Total Delinquent Loans	10	16,988.58
Delinquency Rate**		10.03%

*These figures do not include 48 loans on which claims have been filed.

**[Total delinquent loans divided by loans in repayment ($159,087.17) plus loans in deferment/forbearance ($10,250)]

III. Purpose and Scope

The Commission has conducted three prior program compliance reviews on FITCO. The first review was conducted June 27-29, 1984, the second was conducted March 3-7, 1986 and the third was conducted November 19, 1987 to January 21, 1988. This last review will hereinafter be referred to as the January 1988 review.

As a result of the findings during the January 1988 review the Commission informed FITCO that a follow-up site visit would be scheduled.

The current program compliance review was a combination of the required follow-up discussed in the report of the January 1988 review and was also conducted as a regularly scheduled review as required by regulation of the Commission's top lenders for the two year period of 1/89 to 1/91. The purpose was to ascertain compliance with Federal and State regulations and policies as they pertain to the California Stafford Loans and the Supplemental Loans for Students/Parent Loans for Undergraduate Students, formerly California Loans to Assist Students (CLAS) programs. The follow-up aspect of the review process was to ascertain that effective remedies and procedures had been implemented and that FITCO was also complying with agreements made during the January 1988 review.

A sample of 68 borrower files totalling 69 loans were reviewed in detail. Of the sample, 25 borrowers had a Stafford loan; 19 had both a Stafford and a SLS loan; 12 were SLS only borrowers and 12 were PLUS borrowers. Most were loans disbursed since the time of the last program compliance review, however some were older loans that were being serviced by FITCO.

The following is an analysis of the sample used for the audit.

The 69 loans included the following status or multiple statuses:

CLIPS/CALS application: 1
Non-disclosure Promissory Notes: 10
Multiply disbursed loans: 20
Application/Promissory Note combination: 48
Number of borrowers in repayment: 13
Number of deferments: 2
Number of forbearances: 1
Number of borrowers that have or had collection activity: 3
Loans disbursed 10/20/87 to 12/22/87 in which a 5.5% origination fee was collected and .5% was to be returned or refunded: 2

The borrowers comprising the above sampled files are identified in the report by an alpha letter and number. Refer to Appendix A for a listing of the borrower names and social security numbers.

The focus of this audit was on the following areas:

- Outstanding issues from the January 1988 review
- Items not reviewed during the January 1988 review
- Due diligence in the making and disbursing of a loan
- Due diligence in the servicing of a loan
- Due diligence in the collection of a loan
- Reporting
- Systems Control, Security, and File Maintenance

The audit included, but was not limited to, an examination of:

- Lender practices, policies, and procedures with regard to each of the aforementioned areas
- Individual borrower files
- Promissory notes and repayment schedules
- Collection and/or payment histories
- Lender manifests and various Commission generated reports
- Collection forms and procedures
- Claims processing and forms
- Federal Interest and Special Allowance Billings
- Lender processing of refunds and cancelled loan funds for sold loans

IV. Findings and Recommendations

The following findings and recommendations will focus on the exceptions identified during the field review. These findings were previously discussed with the auditee during the exit interview except where a subsequent finding/question was discovered after the exit interview. Any subsequent item is so identified in the report.

Although this review was broad scoped in nature, it was not intended to be all-inclusive due to time constraints. Therefore, absence of statements in this report regarding specific practices and procedures should not be construed as acceptance, approval, or endorsement of these practices or procedures. The nature of this report does not limit or lessen the lender's obligation to comply with all of the statutory provisions and regulations governing the Stafford Loan, SLS or PLUS loan programs administered by the Commission.

Audit Process Restrictions:

During the field visit at the FITCO site, access to information and documentation was restricted to that which was provided through only the Senior Vice President or the Chief Financial Officer. Discussion with others in the organization who had specific knowledge and involvement in the operations under review could only be done in the presence of one of these two officials.

These restrictions caused delays in obtaining all the necessary documentation to complete the review in a timely manner. Much of the requested documentation had not been received at the end of the field work.

As stipulated in 34 CFR 682.410(c), Guarantee Agency Enforcement Requirements, "A guarantee agency shall take such measures, and establish such controls, as are necessary to ensure its vigorous enforcement of all Federal, State, and guarantee agency requirements...". Subsections (2), (4) and (5) detail the activities of the enforcement requirements. Accordingly, per 34 CFR 682.414(c), Inspection Requirements, the lenders give the Secretary's designee and the guarantee agency access to the lender's records in order to verify the accuracy of the information provided by the lender per 34 CFR 682.401(b)(12) and (13) and the right of the lender to receive or retain payments made under this part.

Major Review Findings and Concerns:

A. FITCO's continued failure to file Lender's Request for Interest and Special Allowance, ED Form 799 (Form 799) and pay Origination Fees as agreed during the January 14, 1988 meeting and as evidenced by:

- Untimely filings of Form 799 in 1986; 1987 and 1988

- **Amount owed for 1987 ($13,328,471) was not paid until 4/88**

- **Estimated $5,580,683 is currently outstanding as of 3/28/89 through the 9/30/88 billing**

Refer to pages 6 - 9

B. FITCO has continued to not provide needed and requested documentation to substantiate amounts reported on quarterly Form 799 billings as evidenced by:

- Outstanding issues remaining from the January 1988 review report

- Engagement letter mailed 1/13/89 informed FITCO of needed Form 799 documentation

- During the on-site visit additional supporting documentation was requested several times but not provided

- Required substantiation by guarantee agency (Commission) of figures reported to USDE on Form 799's could not be made during the on-site review

Refer to pages 9 - 11 and Appendix B

C. Providing computers to schools as an incentive to process loans through FITCO. Documentation has not been produced that verifies that the activity is not an incentive. **This matter is specifically discussed on pages 11-12.**

D. Continued failure, since 1986, by FITCO to forward borrower refunds to current holders in a timely manner as evidenced by:

- **6-7-88 FITCO response shows average late turnaround time of 203 days (233 less 30 for processing) for some 1985 refunds. Average refund was $910.03.**

- Unremitted refunds as of 12/31/87 was: $5,987,069.31

- Unremitted refunds as of 7/31/88 was: $1,256,076.20

- FITCO failed to provide a current status of the 7/31/88 unremitted refund figure

- Current average days late (number less 30 for processing) is 16 days

- Of the late refunds identified, 86% were forwarded late after 7/1/88
- Failure by FITCO to provide requested verification that $684,207.35 in September 1988 refunds received had been forwarded

Refer to pages 13 - 16 and Appendixes C and D

E. FITCO's failure for over one year to refund/credit to borrowers' accounts the .5% origination fee collected for at least 2,458 loans. This is specifically discussed on pages 16 - 19 and Appendix E.

F. Concern over FITCO's continued failure to consistently work the Commission's Rejected Disbursements and Non-Disbursed Loans Reports.

(This was not discussed during the exit but was discussed during a 2/14/89 meeting between FITCO and Commission administration.)

Refer to pages 19 - 21 and Appendix F

DISCUSSION OF MAJOR REVIEW FINDINGS AND CONCERNS:

A. **FITCO's continued failure to file Form 799 quarterly billings and pay Origination Fees as agreed during a January 14, 1988 meeting.**

Background:

Discovery was made during the January 1988 review process of the lender's lack of refiling corrected Form 799's and payment of sums owed USDE for 1987. The payment of origination fees owed to USDE and timely filing of the documents was thoroughly discussed with the lender's top administration and management, representatives of USDE Region IX and the Commission in a meeting held on 1/14/88. During the meeting FITCO agreed:

1. To submit the corrected 1987 Form 799's within 1 1/2 to 2 weeks of the meeting and to submit payment of the approximately 11.5 million dollars that would be owing to USDE upon receipt of the USDE Debit Letter.

   (A Lender Search Report dated 2/28/89 revealed that the lender paid $13,328,471.22 on 4/11/88 for origination fees owed to USDE for 1987 for lender I.D. #828374.)

2. That the lender was to have all future federal Form 799's submitted prior to the end of the subsequent

quarter and payment of the outstanding origination fees was to be made within a 30-day period of time from the date the lender received the USDE Debit Letter. (The Debit Letter instructs lender's with a continual negative balance to submit the funds within 30 days from the receipt of the letter. FITCO has a continual negative balance.)

Findings:

1. **Untimely submission of Federal Form 799's to USDE**

   - Lender I.D. #828374: The March 31, 1988 Form 799 was received by USDE on 11/16/88, 138 days late (7/1/88 to 11/16/88) and not paid as of 3/28/89.

     The September 30, 1988 bill was due by 12/31/88 and had not been submitted. This bill was 87 days late as of 3/29/89, the date of the exit interview. (1/1/89 to 3/29/89).

   - Lender I.D. #829977: The June 30, 1988 Form 799 was received by USDE on 12/29/88, 89 days late (10/1/88 to 12/29/88) and not paid as of 3/28/89.

2. **Non-payment of amounts owing to USDE**

   - Lender I.D. #828374:

As of:	Cumulative Amount Owed:
10/07/88	$ 765,961.46
11/27/88	$3,018,443.28

   - Lender I.D. #829977:

As of:	Cumulative Amount Owed:
7/19/88	$1,405,201.23
1/06/89	$1,404,066.47*

* reflects a decrease because of a credit applied. This credit of $1,134.76 is an error. The correct amount of the credit should have been $21,837.58.

   - Lender I.D. #828374 Estimate for quarter ending 9/30/88:

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The lender was requested on 3/15/89 to provide an estimate of the billing amounts for the 9/30/88 and 12/31/88 billings. **No estimates were provided.**

The September 30, 1986 bill was to have been received by USDE no later than 1/1/89 and had not been received as of 2/28/89. In order to determine an estimate of the September 30, 1988 bill, gross loan amounts guaranteed by the Commission and by the Higher Education Assistance Foundation (HEAF) were obtained for the three months comprising the September 30 quarter.

Commission
gross guarantees: $13,041,412 x 5% = $ 652,070.60

HEAF
gross guarantees: 18,395,295 x 5% = $ 919,764.75

Estimated 5% Origination Fees: $1,571,835.35
Less estimated 25% cancellations: - 392,958.84

Total estimated for 9/30: $1,178,876.51
(net origination fees)

Note: While this estimated figure of $1,178,876.51 does not include adjustments for any subsidized interest or special allowance and includes only an estimated amount for cancellations, it does indicate that a substantial additional sum is owed to USDE in addition to the 4.4 million already billed but not yet paid by the lender.

. **ESTIMATE OF TOTAL OWING USDE:**

Lender I.D. #828374: $4,197,319.79

Lender I.D. #829977: $1,383,363.65*

Estimated total owed: $5,580,683.44**

*$1,405,201.23 less actual credit to be applied of $21,837.58.

**This does not include any estimated sums that will be owing for the 12/31/88 quarterly bill that was to be submitted to USDE by 3/31/89.

Applicable Regulations:

34 CFR 682.401(b)(10)(ii):

A guarantee agency shall ensure that its program, and all participants in its program, at all times meet the requirements of Subparts B,C,D and F of this Part.

Subpart C
34 CFR 682.304(a)(4):

The lender making the loan and any subsequent holder are jointly and severally liable for payment of the origination fee to the Secretary.

34 CFR 682.304(b)(5):

A request for interest benefits and special allowance is considered timely only if it is received by the Secretary within 90 days following the end of the quarter to which the request pertains.

B. **FITCO has continued to not provide needed and requested documentation to substantiate amounts reported on quarterly Form 799 billings.**

1. Outstanding issues from the January 1988 review report:

a) FITCO failed to submit as requested a copy of a billing for lender I.D. #828374 reflecting the adjustments that were to be made for errors on the 3/31/87 billing in which $711,868.00 of 5.5% origination fee loans was reported in Section III instead of Section IV.C. The appropriate decreased adjustment is required in Section III and an increased adjustment is needed in Section IV. Additionally, the base principal amount disbursed on line 1, Section III, of the same 3/31/87 billing should have been $69,376,315. less $711,868.00 instead of $65,998,814.00. **Although requested several times, documentation was never provided to the Commission that this correction had been made.** See Appendix B for lender's responses indicating that the analysis would be submitted or available in July 1988 and again within 60 days from 10/13/88.

b) A comparison of the copies of the Form 799's provided during the January 1988 field review for the quarters ending March 31, June 30 and September 30, 1987 against a Lender Search Report dated 2/28/89 provided by the USDE Processing Center in Iowa revealed that the copies of the quarterly reports provided the reviewer (which were used during the January 1988 on-site visit to balance to lender back-up records) contained different figures for almost all sections of the three reports when compared to the figures USDE shows as reported to USDE by FITCO. As noted above, the lender never indicated to the Commission that any analysis or changes had been completed or reported on the 1987 billings. A copy of the 2/28/89 Lender Search Report and copies of the three Form 799's that were provided to the Commission reviewer during the January 1988 review were given to lender administration for examination and response (as to the discrepancies) during the exit interview held on 3/29/89.

2. The Commission letter sent to the lender 1/5/89 requested that copies of the March 31, June 30 and September 30, 1988 Federal Form 799's be submitted within 15 days of the lender's receipt of the letter. **No response to the letter was received.**

Finding:

FITCO's failure to provide additional needed and requested documentation to substantiate amounts reported on 3/31 and 6/30/88 Form 799 quarterly billings.

1. The Commission's engagement letter sent to FITCO on 1/13/89 indicated that FITCO was to have several items available upon the reviewer's arrival. One of the items listed was the Lender's Request for Interest and Special Allowance (ED Form 799, 8/81) and supporting trial balance sheets.

2. FITCO provided copies of the 3/31 and 6/30/88 Form 799's submitted to USDE. Accompanying the Form 799's were various lender reports. The reports contained conflicting information (see REPORTING section of this report). Additional back-up documents and trial balances for the quarterly Form 799 billings were requested several times during the on-site review time. **The documentation was not provided and therefore confirmation and/or analysis of the figures used on the reports could not be made.**

Applicable Regulations:

34 CFR 682.414(c)(2):

The lender must give access to the lender's records in order to verify the accuracy of the information provided by the lender pursuant to 682.401(b)(12) and (13) and the right of the lender to receive or retain payments made under this part.

34 CFR 682.401(b)(12):

The guarantee agency shall require its lenders to submit information necessary for determining the amount of interest benefits and special allowance payable on guaranteed loans.

34 CFR 682.410(c):

Guarantee agencies are to conduct a comprehensive biennial on-site program review of its lenders. This includes an analysis of the records and documents lenders retain to support the amount of interest benefits and special allowance billed the Secretary.

C. **Providing computers to schools as an incentive to process loans through FITCO. Documentation has not been produced that verifies that the activity is not an incentive.**

Background:

Review of the lender's billing and receipt of funds for the ARIES computers provided to schools had not been made during the January 1988 on-site review. This was because the lender was billing in arrears and the first billing for the period of 7/1/87 to 1/1/88 was going to be sent out in January 1988. The lender was informed that this area would be examined during a subsequent review.

a) Finding:

The lender, during the current on-site review period, was requested to provide copies of the ledger account reflecting the equipment rental payments of $112.50 for each 6 month period (7/1/87 to 1/1/88, 1/1/88 to 7/1/88 and 7/1/88 to 1/1/89) for the 58 California schools shown on a printout, "Nance's ARIES List" provided to the Commission reviewer during the January 1988 field visit. No accounting records were provided by the lender.

[Note: A lender response letter dated 4/10/89 included a computer list ("Brian's ARIES List") comprised of 209 schools (including various branches). The list indicates "Invoices mailed July 1988". Of the 209 shown, 72 have not paid. As reported above, the lender was billing in arrears and therefore documentation of the rental payments for the periods of 7/1/87 to 1/1/88 and 7/1/88 to 1/1/89 have not been provided or addressed.]

b) Finding:

The rental "Agreement" (copy provided during the January 1988 review) used by the lender and signed by schools using the lender's ARIES equipment does not include a rental charge for the ARIES software as clarified as being required in the 2/89 Dear Colleague letter. A copy of a revised Agreement was requested along with a request for the backup justification for the additional rental charge for the monthly rental of the software. Neither item was provided.

Applicable Regulations and/or Policies:

Higher Education Act of 1965, as amended, effective 10/17/86, Section 435(d)(5)and
Dear Colleague Letter, dated 2/89 (89-L-129, 89-S-55, 89-G-157):

Disqualification For Use of Certain Incentives --

"The term "eligible lender" does not include any lender that the Secretary determines, after notice and opportunity for a hearing, has after [October 17, 1986]...offered, directly or indirectly, points, premiums, payments, or other inducements, to any educational institution or individual in order to secure applicants for loans under this part..."

Examples of prohibited inducements: (#5 of 9 listed in the Dear Colleague Letter)

A guarantee agency provides computers to a school, or a lender provides computers or computer software to a school, at below market rental or cost.

Letter from Dewey L. Newman, Deputy Assistant Secretary for Student Financial Assistance dated 8/5/87 to Mr. Deno Evangelista, President, FITCO:

We agree that charging a fair market value for the services FITCO provides to schools participating in the Guaranteed Student Loan (GSL) Program resolves the conflict between our offices concerning the provisions contained in 20 U.S.C. 1085(d)(5).

D. **Continued failure, since 1986, by FITCO to forward borrower refunds to current holders in a timely manner as evidenced by:**

Background:

Identification and submission to the current holder of refund monies received by the lender for sold loans has been an ongoing issue since the 1986 Commission review and report. The 1986 review was administratively closed out conditioned upon the still outstanding refund issue being carried over and included in the January 1988 review of FITCO. See Appendix C.

A listing of 432 borrowers reflecting some 1985 refunds was submitted by the lender with its 6/7/88 response to the refund issue first identified in the 1986 review. The amounts reported show that the average turnaround time for the lender's processing of the refunds was an average of 233 days. If 30 days are allowed for processing, then the average time it took FITCO to process the refunds would be 203 days. The average refund involved in this listing was $910.03.

Finding:

1. Continued untimely forwarding of refunds received.

a) The lender was requested to provide up-dated documentation which would show the status of the outstanding non-remitted refunds identified as part of the 1986 Commission program compliance review. FITCO records indicated that the lender had unremitted refunds outstanding on 12/31/87 of $5,987,069.31 and the last figures provided to the Commission by FITCO showed $1,256,076.20 outstanding in unremitted refunds as of 7/31/88.

The amounts provided during the current on-site review were the same figures, reflecting a balance of unremitted refunds received from 1985 up to 7/31/88, of $1,256,076.20. The lender claimed to have made some progress in the forwarding to the current holders of this outstanding refund account balance since 7/31/88 but was not able to provide any further account documentation.

The following are the amounts provided during this current review: (which are the same as presented to the Commission on 10/13/88)

Unremitted refunds received during 1985:	$ 206,788.25
Unremitted refunds received during 1986:	226,520.99
Unremitted refunds received during 1987:	664,051.11
Unremitted refunds received during 1988 (to 7/31/88):	158,715.85
Total of unremitted refunds as of 7/31/88:	$1,256,076.20

(Note: A lender response letter dated 4/10/89 indicates that of the more than 2000 borrower's comprising the unremitted refund balance of $1,256,076.20, approximately 180 of these have been cleared since 7/31/88. The resulting decrease is approximately $190,000.)

b) The limited review process identified 81 late* refunds. (See Appendix D.) The major observation is that of the 81 late refunds, 70 (86%) were forwarded after 7/1/88 indicating that the lender is again having difficulties in the timely turnaround time for the processing of borrower refunds. The number of days late (number less 30) ranged from 3 to 47 with 16 days late being the average.

* The number of days late was calculated by taking the date the lender received the refund check from the school and counting the number of days until the lender "sent" the check to the current holder (or the date appearing on the FITCO check if the date "sent" was unavailable) less 30 days for lender processing. Note that repeated statements from the lender indicate a refund turnaround time of 5-10 working days. See Appendix C.

An observation was made by the reviewer in thumbing through the volume of computer printout lists of refunds that what appeared to be a fairly timely working of refunds and cancellations during the first part of 1988 has become less timely during the last half of 1988 and early 1989. Rather than observing a positive continuous pattern of improvement in these areas, a trend appeared that indicates that the lender is repeating the pattern of processing refunds and/or cancellations untimely by Commission allowances.

c) Because of inadequacies in the lender's audit trail of refund and cancellation funds received and the resulting forwarding of the same funds, it was extremely difficult to track dollars received v.s. dollars forwarded.

The lender had a staff and/or change in the processing procedure in the Fall of 1988. The switch over from one processing procedure to another resulted in a third interim process during the month of September 1988. It was difficult to adequately trace the dollars received with the same dollars forwarded to current loan holders. However, for most of the month of September 1988 a folder was kept which included a group of deposit slips for 9/29/88 and 9/30/88 and included copies of the FITCO checks written based upon these funds to the current holders. This provided an opportunity to sum the refund deposits and subtract the sum of the resulting checks sent to the current holders as both were contained in the one folder.

The following was found:

* 9/29/88 and 9/30/88 refunds deposited:	$3,305,169.75
**FITCO checks written to current holders for 9/88 refunds:	- 2,620,962.40
Unremitted 9/88 refunds:	**$ 684,207.35**

*This represents 41 different deposit slips for 9/29 and 29 different deposit slips for 9/30/88.

**This represents 19 FITCO checks.

The lender was requested to provide documentation that the $684,207.35 in 9/29 and 9/30/88 refund monies had been forwarded to the borrower's current holder. **No response was provided.**

Applicable Regulations:

34 CFR 682.209(e):

> A borrower's refund received by the lender from a school is to be credited against the amount owed by the borrower on the borrower's loan or if the loan is no longer held by that lender, the lender shall promptly transmit the amount of the refund payment to the holder to whom it assigned the loan

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> with an explanation of the source of payment. Upon receipt of a refund from the original holder of a loan, the current holder shall promptly provide written notice to the borrower that the holder has received the refund.

34 CFR 682.410(c)(2):

> The guarantee agency shall seek prompt repayment of all funds found in those reviews to have been improperly retained by the participants, and monitoring the implementation by participants of corrective actions required by the agency as a result of those reviews.

E. Failure to refund/credit to borrowers' accounts the .5% origination fee collected for at least 2,458 loans.

Background:

The January 1988 review did not include reconciliation of the amounts and procedures used by the lender to refund/return the .5% origination fee collected from disbursements made between 10/20/87 and 12/22/87. A review was undertaken during the current on-site visit.

Findings:

1. FITCO has failed to process the return of .5% origination fees owing to borrowers' for over 1 year.

   a) The lender, under lender I.D. #828374 has 22 loans that are still held by the lender that were found to not have had the .5% excess origination fee credited to the borrowers' outstanding balance. See Appendix E.

   (Note: A FITCO response dated 4/10/89 has provided documentation that 7 of the 22 accounts have now been properly credited with the excess origination fee.)

   b) Approximately 2,458 loans that were originated by UES on behalf of FITCO under lender I.D. #829977 were found to not have been credited with the excess .5% origination fee as of 3/20/89.

2. Discrepancies between FITCO documentation and USDE Form 799 billings

   During the exit interview the lender provided the Commission reviewer with a computer generated list: "First Independent Trust Company Schedule of .5% Due Secondary Market Fiscal 87 & 88" (Schedule). The Schedule appears to cover both

Commission guaranteed loans and "HG" loans, assumed to be HEAF guaranteed loans. Several discrepancies in this documentation when compared to the documentation of amounts billed USDE on Form 799's for the quarters ending 12/31/87 and 6/30/88 have been identified subsequent to the exit interview.

a) Review of the Schedule resulted in the following:

The schedule provided is comprised of 2559 borrowers and/or social security numbers. Included in the list are 101 borrowers whose checks are shown on the printout as being disbursed on 1/08/87, 1/15/87, 1/22/87, 1/29/87, 2/05/87 or 2/12/87.

The first sequestration order under the revised Gramm-Rudman-Hollings Deficit Reduction Law took "initial" effect on October 20, 1987. Therefore loans disbursed in January and February of 1987 should not be included in the lender's listing of fees to be refunded under this sequestration period.

To correct the FITCO Schedule, the 101 borrowers were found to equal $131,307 in gross loan amounts disbursed 1/87 and 2/87. FITCO's Schedule had a report total for "gross loan amounts" disbursed of $5,252,394.00. Therefore, a revised gross loan amount disbursed under the Gramm-Rudman-Hollings Deficit Reduction Law would be:

$5,252,394.00
- 131,307.00

$5,121,087.00 adjusted gross loan amount disbursed per lender's Schedule

Therefore the amount outstanding to be credited to the remaining 2458 borrowers (.5%) would be $25,614.38.

b) Review of the Form 799 billings resulted in the following:

When comparing the above gross loan amount disbursed at a 5.5% origination fee, (excluding the January and February 1987 borrowers appearing on the Schedule) with the figures that were incorporated into the reported and billed amounts on the lender's I.D. #829977 quarterly Form 799 billings, the following is found:

The 12/31/87 Form 799 documentation shows a net processed amount of $13,106,412.89 for 5.5% loans disbursed and cancelled.

According to the lender no 5.5% loan cancellations were received during the quarter ending 3/31/88 due to a "booking error".*

The 6/30/88 documentation for the Form 799 quarterly billing reflects that the net loan amount processed for the period for 5.5% loans was -$155,955, therefore

12/31/87 net loans disbursed @ 5.5%	$13,106,412.89
Less 6/30/88 cancellations reported for 5.5%	- 155,955.00
According to Form 799 figures, outstanding 5.5% loans =	$12,950,457.89

The amount outstanding to be refunded to borrowers based upon the above Form 799 figures (.5%) would be $64,752.29.

*The "booking error" was not reviewed.

Apparent Discrepancies:

Based upon Form 799 figures:	$64,752.29
Based upon the FITCO schedule:	-25,614.38
Amount of observed discrepancy:	$39,137.91

In addition, the lender's Schedule of .5% Due Secondary Market Fiscal 87 & 88 report also raises a question as to why 101 borrowers appear on the schedule as having had an extra .5% in origination fees withheld from their loan checks. Was there an error in the lender's system during 1/87 and 2/87 whereby 5.5% origination fees were being erroneously deducted from borrower checks and never refunded or credited back to the borrowers? The amount in question, owing to borrowers for two years, is $656.54.

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Applicable Regulations:

Federal Budget Reduction Bill of 1987 and
Commission Lender Policy Update, L#87-08, dated 12/28/87:

> Lenders must refund to the borrower any amount in excess of 5.0% charged to the borrower as an origination fee.

34 CFR 682.202(c):

> Permissible charges by lenders to borrowers -- May charge a borrower an origination fee not to exceed the maximum rate specified by Federal statute.

F. Concern over FITCO's continued failure to consistently work the Commission's Rejected Disbursements and Non-Disbursed Loans Reports.

(This was not discussed during the exit but was discussed during a 2/14/89 meeting between FITCO and Commission administration.)

Background:

It is required by State Regulations that lenders report loan status transactions within 45 days of the lender becoming aware of the loan status change. Lenders are provided with the JSAR410F Rejected Disbursement Report. The report is to be worked and appropriate corrections resubmitted. The JSAR417F Non-Disbursed Loans Report, provided quarterly, reflects loans which are greater than 90 days beyond their anticipated disbursement date. The report would show rejected disbursements not corrected and cancellations not reported and/or corrected. The lenders are instructed to also work this report.

Concern:

An examination of the Commission's Lender Services Section's records revealed the following:

1. FITCO has had a continued history of problems in reporting disbursements. It has historically had the largest number of loans in a non-disbursed status.

   The problems with FITCO go as far back as 1985, as illustrated by correspondence to FITCO management. The attached historical summary (Appendix F) of FITCO's Non-Disbursed Loans Report illustrates that beginning with the quarter ending 6/30/87 through the quarter ending 3/31/89, with the exception of one quarter, FITCO has had a gradual increase in loans in this status. A continuing problem with loans in a non-disbursed status illustrates several possibilities with a lender:

a) The lender is ignoring the Commission's Non-Disbursed Loans Reports (JSAR417F), consequently, premiums on disbursed loans are not being paid for loans which have been disbursed.

b) Lender is reporting disbursements but is either failing or unable to work the rejected disbursement reports (JSAR410F). Loans which reject as disbursements will continue to appear on the 417 report.

c) Lender is failing to report cancellations of loan guarantees for which they know must be cancelled.

It should be noted that a lender's failure to satisfactorily report it's disbursements creates problems for secondary markets which are unable to successfully report loan transfers. This failure to satisfactorily report transfers may affect that new holder's ability to perform due diligence. Commission generated borrower change reports are not sent to new holders if the Commission is not aware that a loan has been made as evidenced by the original lender's successful manifesting of disbursements and payment of the corresponding premium fees.

2. The most recent report for the quarter ending March 31, 1989 shows FITCO's 3 lender numbers with a combined total of 11,668 loans in non-disbursed status representing principal loans totaling $25,540,157.00. Premiums owed to the Commission on these loans total $652,945.00. A breakdown of the loans by lender ID are as follows:

Lender	# Loans	Orig. Prin.	Premium $	# Pages
828374	3,040	$ 4,562,775	$ 91,697	151
828411	2,681	6,506,441	141,712	148
829977	5,947	14,470,941	419,536	314

The largest number of the loans in non-disbursed status are tied to FITCO's #829977 for loans which were to be originated by UES. The fact that UES ceased originating for FITCO in April of 1988 illustrates a problem. A lender which has not obtained guarantees for more than 12 months should not have any loans in a non-disbursed status, therefore, it should not have a 417 report for this lender ID.

The current situation with FITCO has the lender assuring the Commission that they are working their non-disbursed loans report. FITCO management has informed the Commission on several occasions that the 417 report will be reduced by the subsequent quarter, however Commission experience is that the two Lender ID numbers associated with FITCO for new loans has shown an increase in their respective 417 reports. The 829977 ID number has been dramatically reduced from the previous quarter due to manifesting of cancellations; however, a very large number of outstanding disbursements remain on the current 417 report. FITCO has informed the Commission that their lack of disbursement information from UES [now Costa Mesa Service Center (CMSC)] has made reconciling the disbursements a difficult task. The problem with the two numbers at FITCO appear to be related to the lender's inability to properly electronically manifest the disbursements. For the first time FITCO is receiving their 417 report and manifesting disbursements electronically which they promise will speed the reconciliation of their accounts.

Applicable Regulations:

State Regulation 30124:

> The California Student Aid Commission shall receive the Lender's Manifest from participating lenders within 45 calendar days of the earliest loan transaction (disbursements, cancellations, and any other transactions) recorded on the Manifest.

The following part of this report covers miscellaneous items/issues found in the review of the 68 borrower files. Also included are additional questions/problems related to refunds and/or cancellations and problems or questions relating to the limited review of the 3/31 and 6/30/88 quarterly Form 799's.

1. DUE DILIGENCE IN THE MAKING AND DISBURSING OF A LOAN

a) Personal Endorsement of Borrower on Check
34 CFR 682.207

A lender shall disburse loan proceeds with a check that is made payable to the borrower or, if required by the guarantor, is made co-payable to the borrower and the school identified on the loan application, and requires the personal endorsement or other written approval of the borrower in order to be cashed.

In order to determine if checks disbursed by the lender were properly endorsed by the borrower (and school if applicable), a sample of names and disbursement dates were provided to the lender during the review. The lender was requested to obtain copies of the front and backs of the checks. The following check copies are still outstanding:

Borrower Code	Bank	Check #	Date of Check
D1	Banker's Trust	08435	12/19/88
C3	Banker's Trust	15858	01/31/89
C3	Sacto. 1st. N.B.	C47467	12/30/88
A7	Banker's Trust	03928	11/14/88

Requested Response:

The lender is requested to provide copies of the above checks.

b) Insurance Premium Charge
34 CFR 682.401(b)(6)
34 CFR 682.202(d)
34 CFR 682.410(c)(2)

The guarantee agency may charge the lender an insurance premium on each loan. The lender may deduct the amount of the insurance premium paid by the lender to the guarantor from the borrower's loan proceeds. The guarantee agency shall seek prompt repayment of all funds found to have been improperly retained by the lender.

Finding:

During the current review, one of the borrower files (H7) reviewed contained an example of the lender overcharging a borrower for a CLAS (SLS/PLUS) insurance premium.

The Commission Disclosure Statement reflects that the premium fee to be charged is $56.10. The lender's disclosure statement and loan check copy for the loan disbursed on 8/3/87 both reflect that the fee charged to the borrower was $75.00. This is an overcharge of $18.90.

Required Action:

The lender is to research this situation and submit the results. Any overcharges found as a result of the research are to be refunded to the borrowers. Documentation to verify that the refund for the above borrower has been credited to the borrower's account is to be submitted.

2. DUE DILIGENCE IN THE SERVICING OF A LOAN

a) Conversion into Repayment for Stafford Loan
34 CFR 682.209(a)

When a lender learns that a borrower is no longer enrolled at a participating school on at least a half-time basis, the lender shall promptly contact the borrower to establish repayment terms. Loans must be converted into repayment status on the first day of the month after the grace period ends. At that time, federal interest billing must cease.

The following loans were found to have been converted late:

Borrower Code: H2:

Anticipated Completion Date: 5/87; 6 mos. grace; not a late notification

Date lender worked the conversion: 3/10/88. Interest was capitalized from 12/1/87 to 3/10/88.

Correct conversion date: 12/1/87.

Period in question: 12/1/87 to 3/10/88

Borrower Code: G12:

Anticipated Completion Date: 12/86; 6 mos. grace; not a late notification

Date lender worked the conversion: 3/10/88. Interest was capitalized from 7/1/87 to 3/10/88

Correct conversion date: 7/1/87

Period in question: 7/1/87 to 3/10/88

Required Response:

The lender is requested to provide documentation as to whether these loans have been included on any Form 799 for subsidized interest billing during the periods in question. If the lender has billed for subsidized interest, then the lender is to provide proof that the necessary decrease adjustments have been taken on a Form 799 submitted after the lender worked the late conversions.

b) Deferments

Finding:

During the review process the lender provided several typed pages in response to questions on some borrower files. One of the responses to a question regarding the determination of a borrower's enrollment status on a deferment form was:

> The Department of Education has always allowed the servicer or lender to make that judgement if the form does not allow for half/time.

Requested Action

The lender is to provide the back-up documentation for this statement.

c) Procedures for the Application of Payments

Finding:

The lender provided a revised procedure for the lender's application of payments on Guaranteed Student Loans in an October 1988 response to the January 1988 review report. The procedure includes the following sentence:

> Any payments received during the last 30 days of grace will be applied as a payment for the current installment unless the borrower specifically sends instruction as to its application.

Requested Action

The lender is requested to clarify this statement.

d) Refunds

The following refund related items were requested of the lender and were still outstanding at the end of the field visit.

1. Pink paper copies of deposit tickets numbered by the reviewer as "2" and "4" to be returned along with the copies of the front and backs of the checks payable to the current holder for the names appearing on the pink sheets attached to "2" and "4".

2. Deposit Slips #50054, dated 11/30/88 in the amount of $116,084.10 and slip #50152 dated 3/8/89 in the amount of $133,191.38 need to be "matched" with lists of borrowers comprising said deposit slips and then copies of the checks payable to the current holder(s) for the list of names coinciding to the deposit slips are to be provided.

3. Copies of the front and backs of the following checks written to the secondary markets for refunds received:

   Check numbers:

   1070-71; 1073-4; 1110-14; 1273-75; 1382-4; 1505-7; 1509-11; 1569-73; 1686-88; 1690; 1700 and 1702

4. Supporting documentation requested for specific refunds was not provided.

Copies of refund checks or other documentation of refunds on FITCO loans were obtained from several Commission school program review staff. After an initial check of the lender's system for the status of any refund received for these borrowers, the list was provided to the lender (on 3/6/89) and it was requested that further research into the status of the refunds be completed and that the results be provided to the reviewer. **No response was provided.** See Appendix G for list of borrower refunds requested to be traced.

Requested Action:

Please provide the requested documentation.

(Note: A lender response letter dated 4/10/89 included many copies of checks payable to secondary markets. Complete individual review of the copies provided has not yet been undertaken. Any check copies provided in the 4/10/89 response do not need to be resubmitted when responding to this report.)

e) Cancellations:
34 CFR 682.410(c)(2)

The guarantee agency shall seek prompt repayment of all funds found in those reviews to have been improperly retained by the participants, and monitoring the implementation by participants of corrective actions required by the agency as a result of those reviews.

Background:

The lender's untimely handling of cancelled loan funds was previously addressed in an audit conducted by the U.S. Department of Education, Office of Inspector General, covering the period of 1/01/84 through 12/31/86.

A letter dated 8/13/86 from Mr. Deno Evangelista, President, FITCO indicated that cancellations were being processed within one week of receipt. See Appendix C, #1.

Finding:

The processing of cancelled Stafford loans appeared to be reasonable during the first half of 1988 but a trend was observed in which late processing, as previously identified in the OIG audit, was reoccurring and that cancelled loan funds are again being forwarded to the current holder in an untimely fashion.

The review reflected that 71 cancelled loans were found to be processed untimely. (i.e. Total number of days from receipt of the returned check from the school to the forwarding of the funds to the current holders, less 30 days for processing time.) Of the 71, 58 (82%) were found to have been for funds received by the lender after 7/1/88. (Refer to Appendix G.)

The average number of days late for the forwarding of funds for the 71 borrowers was 29 days (59 less 30). The range was from 6 to 56 days late.

Required Action:

FITCO is to provide a copy of an enhanced procedure that will state the turnaround time for FITCO's processing of cancelled loan funds and the effective date of the enhanced procedure. FITCO's actual processing time, from date of receipt of the check to be cancelled to the date the funds are actually forwarded on to the current holder, is to be within a maximum time of 30 days.

3. DUE DILIGENCE IN THE COLLECTION OF LOANS

The collection activity was reviewed by examining a sample of 3 loans. As shown on the delinquency chart, the lender only had 10 delinquent loans as of 1/31/89. The collection activity was found satisfactory.

4. REPORTING

a) Incorrectly Reported Transactions

Finding:

Lender records show that the entire loan for (Borrower Code) D9 was cancelled 5/8/87. Commission records show that the second disbursement was cancelled and that the first disbursement of $1313 is still an outstanding loan.

Requested Action:

The lender is requested to make the necessary manifest correction so that the loan will be reflected on the Commission data base correctly and provide documentation that the change has been made.

b) Lender's Request for Interest and Special Allowance

The following is a discussion of the discrepancies noted during the limited review of the documentation that was provided for this section. Be advised that because additional documentation was not provided that these findings do not constitute a full review of this area. See Section B under Major Review Findings and Concerns.

The lender has been submitting two billings per quarter, one under lender I.D. #828374 (FITCO originated loans) and one for I.D. #829977 (UES origination loans on behalf of FITCO.) The copies of the Form 799's provided during this on-site visit were for the 12/31/87, 3/31/88 and 6/30/88 quarters for both I.D. numbers. All bills had been submitted using the Average Quarterly Balance method. Limited computer reports were attached to some of the bills but not enough documentation was provided to reconcile figures used to substantiate the accuracy of the billings. With the limited documents that were provided, the following was found or observed and questioned.

Findings for I.D. #828374:

Section II - Special Allowance

The March 31, 1988 billing reflected an increase in loans made prior to 10/01/81. Comparision between figures reported on the 12/31/87 and the 3/31/88 bill for 7% and 9% loans made prior to 10/01/81 are:

	Balance 12/31/87	Balance 3/31/88	Increase
7%	$83,763.68	$184,615.94	$100,852.26
8%	$ 4,106.03	$ 28,058.00	$ 23,951.97

According to the lender, FITCO purchased a portfolio of loans. The lender was requested on 3/7/89 to provide documentation of the purchase substantiating the increases reported on the 3/31/88 bill and the resale date of the portfolio, if any of the loans have been sold. No documentation was provided.

Section II and Section IV - Special Allowance

The lender was requested to provide supporting detail and General Ledger figures to substantiate the loan balances reported for special allowance on the March 31 and June 30, 1988 billings. The 3/31/88 bill reflects a total special allowance loan portfolio of $34,108,820.03 and the 6/30/88 bill reflects a total special allowance portfolio of $36,215,026.12. No documentation was provided.

Section III - Origination Fee

The detail printed documentation provided for figures used in this section for the 3/31/88 bill contained conflicting information and one report had been manually changed. The manual figures were used on the bill. No reason or documentation as to the reason or source(s) of the manual change was provided, nor explanation between two conflicting printed net disbursement amounts for the quarter of $60,213,343.50 and $82,847,666.50. A figure of $60,214,656.50 was actually reported on line 3 of Section III.

Findings for I.D.#829977

Section III - Origination Fee

The June 30, 1988 billing was returned by USDE for correction. The lender resubmitted the bill. However, the following errors were found during the on-site review.

1. The lender reported as an adjustment on line 2, the 5% origination fee ($13,260.05) instead of the gross amount of the loans cancelled in prior periods. This same figure was also shown on line 3. (No new loans were disbursed and shown on line 1, therefore line 2 and 3 were the same). The result is that USDE calculated 5% of this figure and gave the lender credit for only $663.00 when actually $265,201.00 in cancelled loans should have been shown on lines 2 and 3. The $13,260.05 was the 5% cancelled origination fee credit that USDE would have correctly applied to the lender's outstanding balance owing USDE.

2. The lender's system was not reprogrammed when the 5.5% origination fee collected between 10/17/87 and 12/22/87 was rescinded and therefore the lender's system continued to withhold 5.5% in origination fees for second disbursements made on loans first disbursed during the 10/17/87 to 12/22/87 time-frame.

   While this is still an outstanding issue in that these excess origination fees have not been refunded or credited to the borrowers, the lender erroneously reported the cancellations received for these 5.5% loans on the Form 799 Addendum, Section IV.C. The amount shown on lines 2 and 3 of Section IV.C. is the 5.5% origination fee figure and therefore USDE calculated 5.5% of this figure ($471.76) as a credit to the lender's outstanding balance owing to USDE. The actual amount of cancellations should have been reported of $155,955.00 and this figure should have been included in Section III, lines 2 and 3 (in addition to the $265,201. as noted in #1. above).

Required Action:

The lender is to provide documentation and/or explanation of the discrepancies/questions noted above.

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4. SYSTEMS CONTROL, SECURITY AND FILE MAINTENANCE

System Control

Several issues constituting an apparent lack of FITCO administrative and/or system control have been cited in other parts of this report.

APPENDIX A

SAMPLE LISTING

Review Report Code #	Borrower Name	Social Security #
A1	David Carroll	013-44-6966
A3	Terry Dawson	253-08-3370
A5	Michael Doherty	031-40-4104
A7	Gerald Eichelman	189-44-1779
A9	Alphonso Gardner	041-68-7574
A11	Patrick Harmon	265-69-6073
B1	Kenneth Hrinko	152-50-8633
B3	George Kray	057-64-7622
B4	Robert Lowe	005-66-6467
B6	Bernadette Mancuso	099-38-3481
B8	Thomas McGoverm	015-46-6117
B10	George Pegram	241-88-8523
C1	Gilbert Rager, Jr.	206-38-9419
C3	Lyn Shomers	050-58-1731
C5	Thomas Varievr	075-52-5238
C7	Dennis Ward	533-68-8045
C9	Robert Zahradka	356-16-4935
C11	Calvin Clark	243-21-5939
D1	Stephen Crawford	297-92-7954
D3	Fernando Aguirre	503-20-5761
D4	William Boyd	567-02-5255
D5	Diane Huet	503-60-4301
D7	Lori Lockwood	550-08-4234
D9	Jesse Mesa	567-04-5995
D10	Anita Scherr	503-02-3622
D11	Vershell Williams	567-06-1832
E1	Christine Bocanegra	553-85-8472
E2	Gloria Cox	566-70-2618
E3	Lidia Zapata	610-16-4028
E4	Isela Lopez	566-61-3340
E5	Rosa Ramirez	547-13-6137
E6	Lisa Lew	563-55-9568
E7	Barbara Capute	202-30-0777
E8	Carol Keith	561-65-9862
E9	Michele Schoen	399-84-5759
E10	Kric Kinunen	568-80-3453
E11	Ron Milton	337-44-3153
E12	Christina Cuadros	555-85-1461
F1	Anthony Zaccaglin	557-31-8079
F2	Tammy Martinez	215-78-2706
F3	Ruth Tanner	559-91-0102
F4	Waseem Subhan	530-62-8392
F5	Theresa Gallant	388-86-7658
F6	Adriana Ramirez	552-31-6612
F7	Kathleen Trocine	267-83-1338
F8	Marcelino Cabagbag	557-47-6774
F9	Baby Chavez	558-47-9656
F10	David Frank	523-30-1036
F11	Chyrel Hill	449-76-8606

SAMPLE LISTING, continued

Review Report Code #	Borrower Name	Social Security #
F12	Martin Kimbrell	562-36-4100
G1	Fortunato Lopez	557-02-0318
G2	Estelle Markley	375-50-1841
G3	Diane Mitchell	517-52-1591
G4	Guillermina Reyes	547-55-5190
G5	Juan Rivera	461-82-0325
G6	Helen Thrasher	563-72-0963
G7	Kim Schlievert	559-13-4607
G8	Roberta Keenom	566-23-9467
G9	Carla Ivey	557-29-3571
G10	James Erskine	577-72-4643
G11	Virginia Golden	562-35-1634
G12	Carmela Castellano	555-61-0784
H1	Ronald Jorgensen	554-37-7807
H2	Millie Lyles	552-50-1370
H3	John R. Toman	505-46-2433
H5	Aurplio Gordillo	552-64-7245
H6	Bill Caldwell	558-76-8809
H7	Damian Marcus	497-62-7775

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

CALIFORNIA STUDENT AID COMMISSION
P.O. BOX 942845
SACRAMENTO, CA 94245-0845

July 23, 1987

Deno Evangelista
President
First Independent Trust Company
1020 12th Street
P.O. Box 2310
Sacramento, CA 95811

Dear Mr. Evangelista:

Thank you for your response to the review report generated as a result of the program review of the CGSLP at your institution.

The actions taken and assurances provided are deemed to be satisfactory responses to the discrepancies cited with the following comments/exceptions:

Application of Refunds

The report for the program review conducted March 1986, and sent to the lender July 8, 1986, required that First Independent Trust (FIT) provide an accounting of the monthly refunds received during 1985 from schools. The list was to reflect the timeliness of the lender's actions whereby students accounts were credited or the funds were forwarded to the current holder. Specific dates were requested.

The lender's December 8, 1986 response, Issue #10, included only a schedule of January and February 1985 refunds received and the dates those payments were remitted to the secondary markets.

In a January 12, 1987 CSAC letter to the lender, it was again requested that an accounting for the full 1985 year, as originally required, be submitted.

Another response from FIT on May 4, 1987, stated that the refund schedule for the entire year of 1985 was currently being compiled and would be submitted to CSAC as soon as it is completed.

Since the original written request for the reconstruction of the refund account was received by the lender in July 1986, it is now required that the complete accounting of the 1985 refunds be submitted within 60 days of the lender's receipt of this letter or CSAC will consider taking administrative action against FIT.

The other issues responded to by the lender in the May 4, 1987 correspondence are considered closed for the purpose of the 1986

review. Any future CSAC program compliance review will confirm that the lender is no longer responsible for the cited portions of the loan servicing functions and/or confirm the timely manifesting and working of CSAC reject reports.

Your timely attention to the above requested reconstruction will facilitate the conclusion of this program review report.

If you have any questions, please call me at (916) 324-2294.

Sincerely,

Sydney P. Jamison
Specialist
Program Quality Assurance
California Educational
Loan Programs

cc: Jack Keefe, U.S. Department of Education
Cindy Long, Assistant Vice President, Operations, FIT

SJ:me

APPENDIX C

UNTIMELY REFUNDS

1. A letter dated 8/13/86 to Mr. Richard Reinhardt, Associate Director of the Commission from Mr. Deno Evangelista, President, FITCO, states "...However, my top people assure me that all refunds and cancellations are now being processed within one week of receipt...".

2. A Commission letter dated 7/23/87 to Mr. Evangelista outlined the Commission's attempts to obtain a complete accounting of the refund issue cited in the 1986 review report. **No response was received from the lender.** See copy attached as part of this appendix.

3. A Commission letter dated 2/2/88 administratively closed out the FITCO 1986 program review by carrying over the remaining outstanding issue of Refunds into the recently completed January 1988 program compliance review report.

4. The lender's 6/7/88 response to the program review completed in January 1988 stated:

   Currently, the entire refund accounting process (from receipt of the check from the school to the reimbursement of the secondary market) is averaging approximately 5-10 working days. As we receive the refund checks from the schools and verify that we were the original lender, the checks are deposited into the refund account and a check for reimbursement to the secondary market is requested the same day. We have been operating under this policy since mid-February, 1988. And,

   Attached is a copy of the results of the research with UES records. This comparision was made to complete the accounting for refunds for 1985. The accounting for refunds for 1986 and 1987 will be completed and available to the compliance team upon their return for the follow-up scheduled in July, 1988.

UNTIMELY REFUNDS, continued

5. The lender's 10/13/88 response stated:

> We have made significant progress in our ongoing effort to resolve our refund process. The following is an accounting for the refunds received and subsequently remitted during this time period.
>
> | | |
> |---|---|
> | Total Unremitted Refunds at 1/1/86 | $ 1,449,365.30 |
> | Total Refunds Received During 1986 | 4,349,670.54 |
> | Total Refunds Remitted During 1986 | - 4,841,841.27 |
> | Total Unremitted Refunds at 12/31/86 | 957,194.57 |
> | Total Refunds Received During 1987 | 25,445,927.50 |
> | Total Refunds Remitted During 1987 | -20,416,052.76 |
> | Total Unremitted Refunds at 12/31/87 | 5,987,069.31 |
> | Total Refunds Received Through 7/31/88 | 16,731,718.71 |
> | Total Refunds Remitted Through 7/31/88 | -21,462,711.82 |
> | Total Unremitted Refunds at 7/31/88 | $ 1,256,076.20 |
>
> We have created a separate database dedicated entirely to the reconciliation of these refunds and remittances so that they may be remitted to the appropriate secondary market as quickly and efficiently as possible. We have identified the $1,256,076.20 of outstanding refunds, and are researching the current ownership. We anticipate the entire process to be completed within 60 days. As we stated in our previous response, currently the entire refund process is averaging approximately 5-10 working days from receipt of the refund in our office, to the remittance to the loan holder.

6. A letter was sent from the Commission on 1/5/89 reminding the lender that the accounting of refunds for 1986 and 1987 was still outstanding and the accounting was to be submitted within 15 days of the receipt of the letter by the lender. No response was received.

APPENDIX D

UNTIMELY REFUNDS

The following late refunds were found. The number of days late shown below are the number of days from the date the lender received the refund from the borrower's school, less 30 days for lender processing.

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Jeanette Bethune 157-74-1838	$ 88.00	12/15/88	1/26/89	12
Dawn Riker 141-58-4525	1463.00	12/15/88	1/26/89	12
Michael Henning 556-11-7904	704.81	12/15/88	1/26/89	12
Martin Strum 563-04-1348	1207.04	11/10/88	1/26/89	47
Pamela Burke 545-31-2833	1490.00	12/15/88	1/26/89	12
Milton Chambless 426-29-9756	502.46	12/14/88	1/26/89	13
Pierre Murad 157-74-6759	1200.00	12/15/88	1/26/89	12
Rooney Todd 062-60-2497	135.96	12/15/88	1/26/89	12
Larnetter Way 183-64-1067	1177.00	12/15/88	1/26/89	12
Cynthia Krich 439-41-9951	565.31	12/15/88	1/26/89	12
Barbara Lockwood 454-15-1346	565.31	12/15/88	1/26/89	12
John Jones 427-23-8065	2147.50	12/15/88	1/26/89	12
Dorothy Collins 449-49-6770	767.64	12/05/88	1/26/89	22
Pierre Cotnoir 452-54-0269	354.57	12/05/88	1/26/89	22

UNTIMELY REFUNDS, continued

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Roydell Trent 368-66-5193	$1207.04	12/15/88	1/26/89	12
Barbara Alexander 571-46-9320	1085.93	2/01/88	3/08/88	6
Cherylon Hicks 547-06-8330	207.51	2/01/88	3/08/88	6
Sherie Shaw 554-15-4660	1315.80	2/01/88	3/08/88	6
Donna Stillwell 149-50-3444	6.00	2/01/88	3/08/88	6
Karen Thomas 559-31-5338	41.73	2/01/88	3/08/88	6
Mary Vasquez 561-13-9017	2625.00	2/01/88	3/08/88	6
Byron Wattree 555-31-5741	1011.33	2/01/88	3/08/88	6
Ma E. Mendoza 563-85-6756	2044.99	2/29/88	4/05/88	6
Jamie Wittenau 545-50-1030	797.00	4/04/88	*5/20/88	16
Jack Bankler 130-26-4915	1897.45	3/17/88	*5/20/88	34
Anne Johnson 546-64-3229	135.00	3/29/88	*5/20/88	22
Joseph Rodgers 097-58-1963	1360.92	8/09/88	9/30/88	22
Sandra Delatte 589-30-0623	569.46	8/15/88	9/30/88	16
Evelyn Lewis 069-58-5728	1141.88	8/19/88	9/30/88	12

UNTIMELY REFUNDS, continued

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Don Dickersnan 459-62-5152	700.00	8/19/88	9/30/88	12
Theodore Hall 216-38-5139	187.00	8/15/88	9/30/88	16
Almeade Joyner 248-74-2144	400.55	8/15/88	9/30/88	16
Howard Kerney 427-42-1061	673.77	8/19/88	9/30/88	12
Earl Landry 435-66-0435	60.00	8/15/88	9/30/88	16
Myrtle Pate 439-74-5229	210.85	8/17/88	9/30/88	14
Bradley Shearer 215-66-6243	186.88	8/15/88	9/30/88	16
Arvecta Turner 410-23-7984	128.33	8/19/88	9/30/88	12
Sonya Morley 308-72-6463	149.84	8/19/88	9/30/88	12
George Espada,Jr. 128-58-3588	1936.88	8/09/88	9/30/88	22
Sherrill Bradley 465-90-7707	1474.00	7/18/88	9/30/88	44
Nina Baugh 425-29-0676	387.96	8/12/88	10/04/88	23
Carla Dupre 435-98-5976	477.96	8/15/88	10/04/88	20
Geraldine Harrell 422-02-8843	7.96	8/15/88	10/04/88	20
Gladys Hidalgo 263-91-6363	172.96	8/16/88	10/04/88	19
Cheryl Kelley 276-68-3530	765.96	8/15/88	10/04/88	20

UNTIMELY REFUNDS, continued

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Henry Walker, Jr. 447-60-4658	34.21	8/15/88	10/04/88	20
Joyce Barrett 254-23-0985	159.15	8/26/88	10/04/88	9
Carol Yates 405-74-2244	159.15	8/26/88	10/04/88	9
Melody Roberson 571-11-9464	7.96	8/26/88	10/04/88	9
Baez Mercado 582-17-8260	493.01	8/22/88	10/04/88	13
Malinda Smallwood 526-13-4637	357.96	8/29/88	10/04/88	6
Kimberly Southard 141-76-4927	2077.00	8/23/88	10/04/88	12
Josue VargasMercado 596-01-1751	217.01	8/22/88	10/04/88	13
Judith VargasMercado 596-01-1636	227.01	8/22/88	10/04/88	13
Elaine Vinson 248-04-9917	127.70	8/26/88	10/04/88	9
Karon Dunnigan 232-90-9339	125.50	8/12/88	10/04/88	23
Donna Gresham 207-46-2678	159.15	8/12/88	10/04/88	23
Angela Holdren 248-25-9526	159.15	8/12/88	10/04/88	23
Ramona Krumpe 527-34-1055	159.15	8/12/88	10/04/88	23
Ronald Mills 315-68-7104	1951.26	8/15/88	10/04/88	20
Dolores Ortiz 564-33-0194	162.00	8/31/88	10/04/88	4

APPENDIX D
Pg 5

UNTIMELY REFUNDS, continued

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Barbara Perine 447-40-6410	159.15	8/12/88	10/04/88	23
Judy Pullen 227-04-0867	159.15	8/12/88	10/04/88	23
Roxie Stone 402-02-9279	2472.00	8/18/88	10/04/88	17
Marlene Brown 414-23-7143	327.96	8/18/88	10/04/88	17
Roy Fox 406-54-7151	2086.00	8/15/88	10/04/88	20
Thelma Irving 428-94-6052	200.00	8/04/88	10/04/88	31
Vilma Ayala 553-71-8548	1151.67	9/20/88	** 10/31/88	11
Linda Collins 525-38-8117	2192.00	9/22/88	** 10/31/88	9
Leonidas DeCastro 572-89-1110	802.43	9/26/88	** 10/31/88	5
Tomas Delatorre 550-13-5844	825.00	8/18/88	** 10/31/88	44
Denene Eaglin 548-17-4622	2329.17	9/22/88	** 10/31/88	9
Modesto Fabia 571-65-9781	1700.44	9/26/88	** 10/31/88	5
Kevin Gillen 562-25-8233	163.04	9/20/88	** 10/31/88	11
Margarita Lara 550-65-5097	50.00	9/19/88	** 10/31/88	12
Raymond Newell 559-82-2860	471.88	8/18/88	** 10/31/88	44
Ernest Smith 567-31-1666	120.79	9/20/88	** 10/31/88	11

UNTIMELY REFUNDS, continued

Borrower/SSN	Refund Amount	Date Received	Date Sent to Current Holder	# of Days Late
Frances Trice 429-90-2269	1743.27	9/13/88	** 10/31/88	18
Shawanda Waite 552-37-0041	47.35	9/02/88	** 10/31/88	29
Carolyn Willingham 524-68-6144	13.51	9/28/88	** 10/31/88	3
Stacy Windsor 568-02-1349	2460.12	9/22/88	** 10/31/88	9

* Estimated date that check was sent.
** Date on lender's refund check

APPENDIX E

LENDER I.D. #828374 - .5% ORIGINATION FEE OWING TO BORROWERS

SSN		Borrower	Amt	Old Orig	New Orig	Diff
565-71-0153		Moore, Sandra	$1313	$ 72.22	$65.65	$ 6.57
559-04-3256	*	Hundley, Tony	1313	72.22	65.65	6.57
587-13-2918		Johnson, Janet	1150	63.25	57.50	5.75
565-98-8419		Vansickle-Ward	1824	100.32	91.20	9.12
558-08-3436	*	Taylor, C.	2625	144.38	131.25	13.13
565-31-2772		Franco,Jr., R.	1313	72.22	65.65	6.57
587-13-2918		Johnson, Janet	1150	63.25	57.50	5.75
555-85-6736	*	Papilla, T.	2625	144.38	131.25	13.13
547-11-2678		Hall, Zina	2625	144.38	131.25	13.13
545-33-4566		Stogsgill, B.	1313	72.22	65.65	6.57
554-37-7807	*	Jorgensen, R.	1002	55.11	50.10	5.01
552-55-1435		Cruz, Ruben	1750	96.25	87.50	8.75
482-74-3158		Staal, Cindi	550	30.25	27.50	2.75
568-19-1717		Schneider, J.	1313	72.22	65.65	6.57
563-31-5200		Mack, Isaac	2500	137.50	125.00	12.50
565-31-2772		Franco Jr., R.	1312	72.16	65.60	6.56
554-68-6375	*	Strachan, M.	2625	144.38	131.25	13.13
571-45-4333		Wildemann, T.	769	42.30	38.45	3.85
432-43-8909		Trinh, Andre	1196	65.78	59.80	5.98
565-98-8419		Vansickle-Ward	1822	100.21	91.10	9.11
566-23-9467	*	Keenom, Roberta	580	31.90	29.00	2.90
499-60-1632	*	Taylor, Verlin	2625	144.38	131.25	13.13

*Copies of these seven borrowers' account ledgers were provided in a FITCO review response dated 4/10/89. These seven borrowers have been credited with the excess origination fee collected.

APPENDIX

FITCO NON-DISBURSED LOAN REPORT HISTORY

JP

Quarter Ending	Number of Loans	Original Principal	Owed Premium	Number of Pages
6/30/87				
828374	357	779,418	$ 10,362	18
828411(CLAS)	462	902,261	35,270	25
829977(UES)	258	338,612	4,511	14
9/30/87				
828374	1,563	2,993,753	$ 39,300	78
828411	632	1,685,239	59,037	34
829977(UES)	2,074	4,293,848	125,012	103
12/31/87				
828374	4,428	7,761,690	$121,550	234
828411	2,063	5,783,658	99,032	115
829977(UES)	3,384	8,492,819	224,319	179
3/31/88				
828374	8,467	13,953,479	$246,530	428
828411	3,074	8,627,028	150,669	172
829977	3,102	7,575,970	215,718	105
6/30/88				
828374	3,992	5,835,401	$127,189	197
828411	506	1,133,786	25,571	29
829977	8,073	19,480,408	568,487	426
9/30/88				
828374	3,080	4,476,789	$ 90,765	157
828411	703	1,912,682	39,824	40
829977	10,734	25,395,085	744,005	560
12/31/88				
828374	2,795	4,128,298	$ 82,081	140
828411	2,513	7,213,876	140,984	140
829977	10,588	25,204,030	783,277	549
3/31/89				
828374	3,040	4,562,775	$ 91,697	131
828411	2,681	6,506,441	141,712	148
829977	5,947	14,470,941	419,536	314

BEST COPY AVAILABLE

APPENDIX G

REQUESTED REFUND DOCUMENTATION

The following is a list of the borrower refund checks sent by various schools to FITCO.

Borrower/SSN	School Issuing Check	Date of Check	Amount
Dennis Ward 555-68-8045*	Federal Truck Driving	1/17/89	$ 554.57
	" " "	1/17/89	779.09**
	" " "	1/17/89	1,207.50
	" " "	1/17/89	1,704.78

Status on FITCO system: no refunds found posted

*three checks had a SSN of 553-68-8045
**this check did not have any SSN on it

Shelia Paris 449-90-6595	Donna Lee's Hollywood Scriptwriting Inst.	10/10/88	$ 27.30
Uko Ukoh 554-53-3505	Donna Lee's Hollywood Scriptwriting Inst.	10/10/88	$ 250.00

Status on FITCO system: no refunds found posted for the above two borrowers

Carole Vezien 559-55-3078	Sierra Acad. of Aeronautics	12/23/88	$ 544.00

Status on FITCO system: no refund found posted

Kate Lundy 371-58-7431	Design Insitute of San Diego	2/20/88	$ 215.00

Status on FITCO system: refund received 3/3/88
no information if and when forwarded

Ronald Ryder 547-31-5974	Rancho Arroyo Voc. Technical Inst.	1/13/89	$ 18.40

Status on FITCO system: no SSN available at the time
SSN shown was later obtained from Commission database

Denise Bynum 565-96-4094	System Programming Dev.	11/14/88	$ 146.50

Status on FITCO system: received 11/28/88
no information if and when forwarded

REQUESTED REFUND DOCUMENTATION, continued

Ammon Wong Nordco Inc. 12/30/88 $ 2500.00
571-23-4229

Status on FITCO system: SSN not on system

Michael Apostoli
558-31-8549 Nordco Inc. 12/30/88 $ 3703.75

Wendy Olivera Nordco Inc. 12/30/88 $ 2625.00
566-25-3149

Status on FITCO system: no refund found posted.

7 borrowers' refunds were included in this 12/30/88 check from Nordco Inc. Since one SSN could not be found and two others did not reflect a refund being received, the other four names were not pulled up on the lender's computer system as it appeared that the check had not been processed.

Colleen Harrison
556-29-4728 Carmichael Beauty Coll. 11/23/88 $ 2500.00

Status on FITCO system: SSN could not be found

Julie Davis Carmichael Beauty Coll. 10/5/88 $ 511.00
550-47-8743

Status on FITCO system: refund received 10/21/88, funds forwarded 10/24/88

The following borrowers were on a list from Wilshire Computer College. The school indicated that the refunds had been mailed as of 1/20/89.

(For the first three borrowers shown below FITCO did not have the SSN on file)

	Amount of Refund
Lillian Benitez 583-82-5732	$ 612.00
Pedro Hernandez 567-56-6524	540.00
Kenneth Tatum 470-31-2487	1630.00

REQUESTED REFUND DOCUMENTATION, continued

No refund found posted on FITCO's system for the following:

Wilma Dailey 458-80-9484	$ 690.00
Moses Griffin 383-58-3125	1290.00
Granvel Johnson 534-60-5970	1350.00
Archie Taylor 436-54-1637	1721.00
Andrew Thomas 414-00-1977	145.00
Joe Zetino 579-35-9130	790.00

APPENDIX H

UNTIMELY CANCELLATIONS

The lender's handling of after sale Stafford loan cancellations for the period beginning with lender cancellation reports dated from January 1988 were reviewed.

Examples

The following 19 borrowers were found to have had their cancelled loan funds forwarded to the current holder in excess of a 30-day period from the date the check was returned by the school for cancellation until the time the lender sent out a check to the current holder.

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
Julia Collart 570-53-4817 $1312	1/06/88	3/04/88	58	28	438
Debra Lownsbury 291-58-5378 $1313	2/29/88	5/06/88	67	37	463
Anna-Renee Allen 248-17-3041 $619	3/24/88	5/06/88	43	13	465
Josephine Austin 564-47-4087 $1313	3/22/88	5/06/88	45	15	465
Pamela Kilpatrick 571-17-6101 $1313	2/16/88	5/06/88	80	50	465
Barbara Martin 341-66-2284 $1007	2/22/88	5/06/88	74	44	465
Lisa Rodriguez 572-15-2327 $1313	2/16/88	5/06/88	80	50	465

APPENDIX H
PG. 2

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
Denton Glasco 553-25-7082 $1313	6/06/88	7/29/88	53	23	510
Jerlyn Doyle 570-25-9552 $1313	6/06/88	7/29/88	53	23	510
Alvin Johnson 546-45-3909 $	6/15/88	7/29/88	44	14	510
Tray Martin 547-17-8910 $1313	6/06/88	7/29/88	53	23	510
Thomas Tweh 555-83-3359 $1313	6/06/88	7/29/88	53	23	510
Marjorie Vann 555-31-3676 $1312	5/04/88	7/29/88	86	56	510
Viopapa Bernard 558-69-5030 $1313	8/02/88	9/20/88	49	19	583U
Lugenia Brown 444-54-2072 $1313	8/02/88	9/20/88	49	19	583U
Mary Carter 558-67-2633 $1313	8/08/88	9/20/88	42	12	583U
Ruth Lopez 566-13-6735 $1313	8/02/88	9/20/88	49	19	583U
Patsy McKenzie 613-03-3042 $1313	8/02/88	9/20/88	49	19	583U

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
John White 430-25-7057 $1313	8/02/88	9/20/88	49	19	583U

Examples

In order to examine the lender's current processing of cancelled loans, 5 recent cancelled Stafford loans were reviewed. The 5 borrowers had their checks returned to the lender by the school in December 1988. It was found that these checks were not processed by the lender until February 1989. The lender's after sale cancellation reports for February also reflected many more cancelled loan funds processed and forwarded to the secondary market in excess of a 30-day processing period. The five borrowers in the sample are denoted with an * preceding their name.

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
Mark Assenberg 514-64-6073 $2625	12/19/88	2/10/89	53	23	659C
Deborah Bailey 568-08-9251 $1313	12/19/88	2/10/89	53	23	659C
Charlene Benz 552-84-4633 $266	12/15/88	2/10/89	57	27	659C
Sharon Cooper 567-25-8402 $1313	1/03/89	2/10/89	38	8	659C
*Michael Doherty 031-40-4104 $2625	12/19/88	2/10/89	53	23	659C

APPENDIX H
PG. 4

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
*Gerald Eichelman 189-44-1779 $2625	12/19/88	2/10/89	53	23	659C
Billy Evans 257-04-2309 $2625	12/16/88	2/10/89	56	26	659C
Shelly Fierling 537-06-0789 $2625	12/19/88	2/10/89	53	23	659C
Carmen Flores 560-55-9649 $2625	12/08/88	2/10/89	64	34	659C
*Alphonso Gardner 041-68-7574 $2625	12/16/88	2/10/89	56	26	659C
*Patrick Harmon 265-69-6073 $2625	12/19/88	2/10/89	53	23	659C
Kevin Hood 542-98-1960 $2625	12/19/88	2/10/89	53	23	659C
April Marinos 515-79-0625 $1275	12/14/88	2/10/89	58	28	659C
Danny Moore 426-19-7296 $2625	12/08/88	2/10/89	64	34	659C
Carmen Nieves 558-69-7892 $2625	12/08/88	2/10/89	64	34	659C
*George Pegram 241-88-8523 $2625	12/19/88	2/10/89	53	23	659C

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
Jeffrey Reece 539-84-6405 $2625	12/19/88	2/10/89	53	23	659C
Rick Rogers 535-70-3941 $2625	12/19/88	2/10/89	53	23	659C
Michele Schweppe 508-04-0986 $1313	12/08/88	2/10/89	64	34	659C
Floyd Sibley 535-52-6912 $2625	12/19/88	2/10/89	53	23	659C
Desmond Spearman 538-62-0694 $2625	12/19/88	2/10/89	53	23	659C
Ardie Taylor 570-06-0023 $1212	12/14/88	2/10/89	58	28	659C
Leonard Thompson 534-54-7981 $2625	12/19/88	2/10/89	53	23	659C
Paul Veillard 538-64-6908 $2625	12/19/88	2/10/89	53	23	659C
Donald West 535-58-1028 $2625	12/19/88	2/10/89	53	23	659C
Victor Delgadillo 550-11-3564 $2265	12/27/88	2/10/89	45	15	659W
Diana Falcon 555-77-6541 $1100	12/27/88	2/10/89	45	15	659W

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amt.	Date Check Rec'd by Lender	Date Funds Sent to Current Holder	Total # of Days	Numb. of Days Late	Ref. Num.
Vickie Harris 551-15-0377 $1313	12/30/88	2/10/89	42	12	659W
Maria Hernandez 553-04-4836 $1313	12/27/88	2/10/89	45	15	659W
Christine Kaufman 556-57-3105 $1312	12/27/88	2/10/89	45	15	659W
Francine LaBrie 167-34-2937 $2625	12/27/88	2/10/89	45	15	659W
Eden Laxanana 622-14-8838 $1200	12/27/88	2/10/89	45	15	659W
Eddie Martin 554-08-2487 $1173	12/27/88	2/10/89	45	15	659W
Desiree Nelson 550-98-9450 $1313	1/05/89	2/10/89	36	6	659W

The lender was requested to provide a copy of the back and front of the check(s) for Reference #668 so that the timeliness of the lender forwarding the funds for this particular Reference number could be determined. No check copy was provided during the field visit. All of the 18 California Stafford loan borrowers appearing on the cancellation print-out dated 2/24/89 had their cancelled funds forwarded late. Because the lender failed to provide a copy of the requested check(s) during the field visit, the calculations shown below are based upon using 2/24/89 as the "trigger" date for determination if the funds were forwarded untimely. Thirty days for lender processing have been subtracted from the calculation of the number of days late for each borrower.

It is noted that the checks sent by the lender to the secondary markets for cancellations consistently have been sent later than the

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UNTIMELY CANCELLATIONS, continued

date of the print-out report and later than the date that appears on the face of the check.

Borrower/SSN Loan Amount	Date Check Received by Lender	Number of Days Late
Israel Arce 350-69-7950 $1312	12/12/88	44
Scott Cassassa 561-25-8581 $2625	12/12/88	44
Natasha Cunningham 568-39-4225 $1312	12/12/88	44
David De Anda 620-07-4039 $1313	12/12/88	44
Alisha Dennis 560-11-0552 $1212.50	12/12/88	44
Oscar Hernandez 567-99-5364 $1312	12/12/88	44
Debra Jackson 571-19-2979 $1312	12/12/88	44
Brian Johnson 570-15-1498 $2625	12/12/88	44
Deidre Kolen 551-45-4016 $1312	12/12/88	44
Paul Larson 515-68-9796 $2625	12/12/88	44

UNTIMELY CANCELLATIONS, continued

Borrower/SSN Loan Amount	Date Check Received by Lender	Number of Days Late
Joe Leyva 558-17-3314 $2625	12/12/88	44
David Mack 536-36-8575 $2625	12/12/88	44
Melvin McCray 558-21-9528 $1312	12/01/88	55
Lanu Naueahu 529-27-4900 $2625	12/12/88	44
Jose Rodriquez 569-55-8956 $1313	12/12/88	44
Nancy Spivey 533-85-8754 $1170	12/16/88	40
Dolores Vazquez 569-92-0804 $1250	12/12/88	44
Alicia Venegas 612-05-3638 $1312	12/12/88	44

Senate Permanent Subcommittee
on Investigations
EXHIBIT # 33

INDEMNIFICATION AGREEMENT

This Indemnification Agreement is entered into this 8th day of December 1989 between the Department of Education ("ED") and Bank of America, as Trustee for the California Student Loan Finance Corporation ("CSLFC") trust indentures (the "Trustee"). This agreement incorporates ED's May 24, 1989 letter to the Trustee, as modified in writing. ED and the Trustee further agree as follows:

1. ED agrees that, with the exceptions noted in paragraph 2 below, all loans held by the Trustee that were formerly serviced by United Education & Software ("UES loans") for which claims have not been paid by a guarantor or ED as of the date of this agreement are now eligible for guarantee or reinsurance coverage in accordance with the following conditions. The "Eligible Loans" include:

   (a) All UES loans that were in interim status (in school or in grace), in current repayment, or in a valid deferment or forbearance status as of November 1, 1988, shall be eligible for guarantee or reinsurance coverage if such loans otherwise satisfy applicable ED and guaranty agency requirements;

   (b) All UES loans which first became delinquent on or after November 1, 1988 shall be eligible for guarantee or reinsurance coverage subject to applicable ED and guaranty agency requirements;

(c) All other UES loans not identified in subparagraphs (a) or (b) above which were delinquent prior to November 1, 1988, and which otherwise satisfy applicable ED and guaranty agency requirements, shall be eligible for guarantee or reinsurance coverage subject to the terms of the Cure Bulletin (88-G-138);

(d) All UES loans which were eligible for guarantee or reinsurance in accordance with the requirements of 34 C.F.R. 682, subpart D at the time of the borrower's death, disability or bankruptcy shall be eligible for guarantee or reinsurance coverage subject to applicable ED and guaranty agency requirements.

2. The parties hereto agree that the following loans shall not be covered by the terms of this agreement and the Trustee agrees to take steps to ensure that no claims for any loans in these categories will be submitted pending further discussions with ED: (1) UES loans for which the borrower history file reflects an entry created by the "FIX 2187" or "COMFIX" programs run by UES; (2) UES loans for which fictitious borrower references may have been added to the borrower history file; or (3) UES loans which were paid as claims between September 1, 1987 and May 24, 1989.

3. ED agrees to inform all affected guarantors that ED will pay reinsurance on all Eligible Loans and that ED will not return these loans to the guaranty agencies or seek reimbursement from the guaranty agencies in the event that ED subsequently determines that, because of a due diligence violation committed by UES which

has not been cured or because of fraud or intentional misconduct, an Eligible Loan was not legally entitled to guarantee or reinsurance coverage at the time a claim was paid, or the loan was not eligible for cure.

4. In the event that, after ED pays an insurance or reinsurance claim or after a guaranty agency pays a guarantee claim on an Eligible Loan, ED determines that, because of a due diligence violation committed by UES which has not been cured the loan was not legally entitled to guarantee or reinsurance coverage at the time the claim was paid, or the loan was not eligible for cure, ED may demand that the Trustee repurchase the loan. On behalf of the CSLFC indentures, the Trustee agrees to cause such loans to be repurchased on demand by ED within thirty days of receipt of written notice from ED identifying the loans that are to be repurchased and stating the reasons for and factual basis of its demand. At the time of the repurchase, ED shall provide the Trustee all documentation necessary to transfer legal ownership of the loans. Nothing in this agreement shall require or apply to any repurchase of loans arising from the actions or inactions of a guaranty agency or a loan servicer other than UES.

5. The purchase price to be paid for all loans repurchased pursuant to this agreement shall be the amount of the claim paid on the loan, plus interest at the rate charged to the borrower, calculated on the unpaid balance of the loan from the date of the claim payment through the date of repurchase, less payments received from the borrower by ED or the guaranty agency. ED agrees

to pay from the purchase price any amounts that may be owing to a guaranty agency on a loan repurchased pursuant to this agreement.

6. In the event that a repurchase demanded by ED pursuant to this agreement is not completed within 30 days of receipt of a written demand from ED as described in paragraph 4 above, the Trustee agrees that ED may exercise a right of offset in a total amount equal to the purchase price for loans ED has determined must be repurchased. This offset may be either directly against amounts owed by ED to the Trustee or through one or more guaranty agencies for claim payments owed the Trustee. The Trustee agrees that ED may exercise this right of offset without first affording the Trustee any applicable administrative appeal rights. However, nothing in this agreement shall be deemed a waiver of the Trustee's right to a subsequent administrative appeal or the Trustee's right to challenge, in any appropriate forum, a determination by ED that a loan is ineligible for reinsurance or to seek to recover from ED any amounts paid under this agreement.

7. The Trustee agrees to continue to cooperate reasonably with ED in identifying to ED UES due diligence violations that would disqualify loans from eligibility for insurance or reinsurance.

8. A determination by ED that a loan must be repurchased pursuant to this agreement as a result of a due diligence violation committed by UES which has not been cured shall not affect the availability of cure procedures under Bulletin G-138, if such loan qualifies for such treatment. Nothing in this agreement shall be construed as an agreement by ED that any loan that ED or the

Trustee has reason to believe has been affected in any way by fraud or intentional misconduct is eligible for guarantee, reinsurance coverage, or cure, whether or not such loans were submitted for guarantee or reinsurance payment.

9. Except as expressly provided herein, nothing in this agreement shall represent a waiver of any rights of the Department or the Trustee, including any rights afforded by contract, statute or regulation.

Dated: December 9, 1989

Roberta S. Dunn
Dr. Roberta Dunn
Deputy Assistant Secretary
Office of Student Financial Assistance
U.S. Department of Education

Dated: December 8, 1989

Brendan Gallaher
Brendan Gallaher
Vice President
Bank of America, as Trustee for the CSLFC Indentures

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 34-C

SETTLEMENT AGREEMENT

among

BANK OF AMERICA NATIONAL TRUST & SAVINGS ASSOCIATION
(in its individual capacity),

BANK OF AMERICA NATIONAL TRUST & SAVINGS ASSOCIATION
(not in its individual capacity but solely as trustee),

UNITED EDUCATION & SOFTWARE,

and

UNITED EDUCATION & SOFTWARE, INC.

October 28, 1988

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SETTLEMENT AGREEMENT

This **SETTLEMENT AGREEMENT** (this **"Agreement"**) is made and entered into as of October 28, 1988 among BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, in its individual capacity (**"BofA"**), BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, not in its individual capacity but solely as trustee under the Indentures (as defined below) (**"Trustee"**), UNITED EDUCATION & SOFTWARE, a California corporation (**"UES"**), and UNITED EDUCATION & SOFTWARE, INC., a Delaware corporation (**"UESI"**).

RECITALS:

A. Trustee, UES, and California Student Loan Finance Corporation, a California nonprofit public benefit corporation, are parties to a Servicing Agreement among them dated November 1, 1987, as amended, pursuant to which UES undertook to act as servicing agent for certain student loans made in accordance with the Higher Education Act and acquired by Trustee on behalf of and for the account of CSLFC.

B. The parties desire to settle disputes that have arisen under the UES Servicing Agreement, including without limitation through the sale by UES to BofA of certain assets of UES used primarily in servicing such student loans and the release by BofA, Trustee, and others of claims that they may have against UES, UESI, and others and that UES, or UESI may have against BofA, Trustee, and others.

C. In order to induce BofA and Trustee to enter into this Agreement, UESI desires to guarantee the performance by UES of all of the obligations of UES contained in this Agreement.

THE PARTIES THEREFORE AGREE AS FOLLOWS:

ARTICLE 1
DEFINITIONS; EFFECTIVE DATE; LIMITED EFFECTIVENESS

1.1 **Definitions**. The following terms have the meanings specified in this Article 1 for all purposes of this Agreement:

(a) **"Accrued"** means an item as accrued on UES's books in accordance with GAAP, whether or not payable at the time accrued.

(b) **"Affiliate"** means (i) with respect to any natural person, another natural person related not more remotely than first cousin to such person, (ii) with respect to any corporate person, any present or past shareholder, director, officer, or employee of such person, and (iii) with respect to any natural person referred to in clause (i) or clause (ii), any corporation, partnership, trust, or other entity of which such person or relative is the holder directly or indirectly of not le than 5% beneficial interest or of which such person or relative i a director, officer, general partner, or trustee.

(c) "**Bankruptcy**" means the commencement of any proceeding or case seeking (i) the entry of an order for relief under the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq. (ii) the liquidation, reorganization, dissolution, or winding-up a person or the composition or readjustment of a person's debts, (iii) the appointment of a trustee, receiver, custodian, liquidator, or the like of a person or all or substantially all o a person's assets, or (iv) similar relief in respect of a person under any other law relating to insolvency, reorganization, winding-up, or composition or adjustment of debts.

(d) "**Best knowledge**" is defined in Section 12.5.

(e) "**Book Value**" of an asset of a person means the value recorded for that asset in the books and records of such person, net of depreciation and amortization and otherwise in accordance with GAAP, as certified by an officer of such person, and (in the case of UES's assets) as certified at UES's expense by Peat Marwick Main & Co. or other independent certified public accountants reasonably acceptable to BofA.

(f) "**Cash Collateral**" is defined in Section 7.8(d)(i).

(g) "**CERCLA**" is defined in Section 3.26.

(h) "**CSLFC**" means California Student Loan Finance Corporation, a California nonprofit public benefit corporation.

(i) "**Contracts**" is defined in Section 2.1(f).

(j) "**Disclosure Schedule**" means, collectively, the disclosure documents in which UES discloses information called for by this Agreement, with specific reference to each particular Section calling for such disclosure.

(k) "**Effective Date**" is defined in Section 1.2(a).

(l) "**Eligible Repurchase Assets**" means any Purchased Assets of a type listed in Schedule 2.5.

(m) "**Employees**" means the employees of UES engaged primarily or in part in the Servicing Function as of the Effective Date; but notwithstanding the foregoing, the "Employees" shall not include James Bittner.

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(n) "E&O Policy" means the errors and omissions insurance policy retroactively dated November 19, 1985 issued to UES by National Union Insurance Company.

(o) "Equipment" is defined in Section 2.1(a).

(p) "Equipment Leases" is defined in Section 2.1(b).

(q) "ERISA" means the Employee Retirement Income Security Act of 1974, as amended, and all rules, regulations, directives, and guidelines promulgated thereunder.

(r) "Excluded Assets" is defined in Section 2.2.

(s) "Extraordinary Expenses" means any expense item outside the ordinary course of UES's business, including without limitation any items arising from the effects of extraordinary, unusual, or infrequently occurring events and transactions (as defined in APB Opinion No. 30 (June 1973)) and any fees due from UES to any outside consultant, including without limitation Peat Marwick Main & Co.; but notwithstanding the foregoing, "Extraordinary Expenses" does not include any expenses of a type described in Schedule 1.1(s), it being agreed however that Schedule 1.1(s) is not intended to cover any fees due from UES to Peat Marwick Main & Co. or any other consultant to UES and UESI, except (A) fees due to Peat Marwick Main & Co. incurred since October 3, 1988 with respect to (i) quality assurance reviews on the online change of status, hold file batch update, cash update, and electronic recoveries programs, and (ii) efforts to compile and transmit documentation related to the regulatory requirements matrix, the skiptracing functional requirements, and capacity planning, and (B) fees due to KRH Systems Consulting and other contract programmers with respect to the matters described in clause (A)(i).

(t) "Final Closing Date" means November 27, 1988 or such other date to which BofA, Trustee, and UES may agree in writing.

(u) "Final Expiration Date" means the earlier to occur of (i) the Final Closing Date or (ii) the delivery by BofA or Trustee to UES of a written notice stating that the Final Closing Date will not occur.

(v) "Financial Statements" is defined in Section 3.7.

(w) "GAAP" means generally accepted accounting principles, consistently applied for a period and with respect to changes from preceding periods.

(x) "Guaranty" means the guaranty of UESI described in Section 11.1.

(y) "Hazardous Waste" is defined in Section 3.26.

(z) "Hazardous Substance" is defined in Section 3.26.

(aa) "Higher Education Act" means the Higher Education Act of 1965, as amended from time to time, and all rules, regulations, directives, and guidelines promulgated thereunder.

(bb) "Indemnified Party" and "Indemnifying Party" are defined in Section 10.3(a).

(cc) "Indentures" means any indentures of trust between CSLFC and BofA (or any other successor trust company or bank appointed in accordance with the terms of such indentures of trust) as in effect on the date of this Agreement and relating to notes, bonds, and other evidences of indebtedness of CSLFC secured by Student Loans, including without limitation the Indentures of Trust dated as of July 15, 1982, April 1, 1984, March 1, 1985, November 1, 1985, December 1, 1985 (three Indentures), July 1, 1986 (two Indentures), August 1, 1986, June 1, 1987, August 1, 1987, November 1, 1987, and March 1, 1988, each as amended, and all Additional Bank Note Indentures (as defined in such Indentures of Trust) referred to in such Indentures of Trust.

(dd) "Intangible Property" is defined in Section 2.1(c).

(ee) "Interim Closing Date" means the first business day following the date when both of the following have occurred: (i) the Effective Date has occurred, and (ii) Trustee has obtained consents to its performing this Agreement from each of the Letter of Credit Banks.

(ff) "Interim Period" means the period from (and including) the Effective Date to (but excluding) the Interim Period Expiration Date.

(gg) "Interim Period Expiration Date" means the earliest to occur of (A) the Interim Closing Date, (B) the delivery by BofA or Trustee to UES of a written notice stating that the Interim Closing Date will not occur, and (unless extended by each of BofA and Trustee in their sole discretion) (C) October 31, 1988.

(hh) "Lease" is defined in Section 2.1(e).

(ii) "Letter of Credit Banks" means collectively BayBank Boston, N.A. as agent for The Sumitomo Trust and Banking Company, Limited, New York Branch; BayBank Boston, N.A. as agent for The Mitsubishi Bank Limited, New York Branch; The Bank of

Tokyo, Limited, New York Agency; Citibank, N.A.; Cooperatieve Centrale Raiffeisen-Boerenleen Bank B.A. (Rabobank Nederland), New York Branch; The Dai-Ichi Kangyo Bank, Limited, Los Angeles Agency; The Dai-Ichi Kangyo Bank, Limited, Los Angeles Agency, as agent for itself, The Sumitomo Trust and Banking Co., Ltd., Los Angeles Agency, and The Mitsubishi Trust and Banking Corporation, Los Angeles Agency; The Dai-Ichi Kangyo Bank, Limited, Los Angeles Agency, as agent for itself and Cooperatieve Centrale Raiffeisen-Boerenleen Bank B.A. (Rabobank Nederland), New York Branch; The Dai-Ichi Kangyo Bank, Limited, New York Branch; The Fuji Bank, Limited, Los Angeles Agency; The Industrial Bank of Japan, Limited, Los Angeles Agency; The Mitsubishi Bank, Limited, New York Branch; The Mitsubishi Trust and Banking Corporation, Los Angeles Agency; The Sanwa Bank, Limited, New York Branch; The Sumitomo Trust & Banking Co., Ltd., Los Angeles Agency; and The Sumitomo Trust & Banking Co., Ltd., New York Branch.

(jj) "**New Servicer**" means the party to the New Servicing Agreement that will perform the Servicing Function with respect to Student Loans.

(kk) "**New Servicing Agreement**" means a written contract to be entered into among CSLFC, Trustee, and the New Servicer providing inter alia for the New Servicer to service the Student Loans previously subject to the UES Servicing Agreement.

(ll) "**Notifying Party**" is defined in Section 10.3.

(mm) "**Ordinary Expenses**" means all Accrued expenses of UES, other than Extraordinary Expenses, to the extent such expenses (i) relate to the Servicing Function as mutually determined by UES and Trustee and (ii) are then being incurred by UES as a direct result of its ongoing performance of the Servicing Function; but notwithstanding the foregoing, "Ordinary Expenses" does not include allocated overhead, depreciation, or amortization.

(nn) "**Other Assets**" means the assets of UES that are or have been used in part, but not primarily, in the Servicing Function, all of which are listed on Schedule 2.1, Part I.

(oo) "**Payment Period**" means the period of time that begins on the Effective Date and ends 18 months after the Effective Date.

(pp) "**PBGC**" is defined in Section 3.23.

(qq) "**Post-Closing Payment**" is defined in Section 7.8(a).

(rr) "**Purchase Price**" is defined in Section 2.4(a).

(ss) "**Purchased Assets**" means the assets of UES consisting solely of (a) the Servicing Function Assets and (b) such of the Other Assets as BofA may purchase in accordance with Section 2.3(a) or 2.3(b), and expressly excludes the Excluded Assets.

(tt) "Records" is defined in Section 2.1(d).

(uu) "Repurchase Date" means (i) the first business day to occur 90 days after the Effective Date, or (ii) such later date prior to the date that is 180 days after the Interim Closing Date as may be designated in writing by BofA.

(vv) "Senior Management" means all corporate officers and all managerial employees who report directly to corporate officers, as such persons exist(ed) as of the relevant date(s).

(ww) "Servicing Function" means the service required to be performed by UES under the UES Servicing Agreement in connection with Student Loans covered by the Indentures prior to the termination of the UES Servicing Agreement, including without limitation the satisfaction of applicable regulatory requirements through loan application tracking, inquiries, insurance, disbursements, billing, telephone contacts, collections, default claims, and all reporting requirements of the Student Loan owner and appropriate government agencies and Guarantors (as defined in the UES Servicing Agreement).

(xx) "Servicing Function Assets" means the assets of UES that are or have been used by UES primarily in the Servicing Function.

(yy) "Student Loans" means any and all student loans required to be serviced by UES pursuant to the UES Servicing Agreement.

(zz) "Transfer" is defined in Section 2.3.

(aaa) "UCC" means the Uniform Commercial Code as in effect in the State of California.

(bbb) "UESI" means United Education & Software, Inc., a Delaware corporation and the beneficial and record owner of 100% of the outstanding capital stock of UES.

(ccc) "UES Servicing Agreement" means the Servicing Agreement dated November 1, 1987 among Trustee, UES, and CSLFC, as amended by that certain letter among them dated February 29, 1988, together with any prior servicing agreements among those parties.

1.2 Effectiveness.

(a) Effective Date. This Agreement shall become effective on the first date (the "Effective Date") when all of the following have occurred: (i) all parties have executed this Agreement, (ii) BofA, Trustee, and UES have agreed upon the terms of a press release by UES and/or UESI announcing the transactions contemplated by this Agreement, and on the terms of a written communication to be delivered to Employees on the Effective Date, and (iii) BofA and Trustee have received the written opinion of Baker & McKenzie, counsel to UES, in form and substance satisfactory to each of them, to the effect that this Agreement and the performance by UES of its obligations hereunder have been duly authorized.

(b) Obligations of the Parties Prior to Interim Period Expiration Date.

(i) During the Interim Period, UES shall perform the Servicing Function in the ordinary course of its business.

(ii) Trustee shall reimburse UES (or cause UES to be reimbursed) for all Ordinary Expenses (including without limitation direct Employee costs (such as salaries, wages, and obligatory employee benefits and government payments, but excluding discretionary employee benefits unless otherwise agreed in writing)) and for depreciation and amortization (but not in excess of $32,000 per month, prorated for partial months) that are Accrued for the account of UES from October 3, 1988 through the Interim Period Expiration Date in connection with the Servicing Function. UES shall submit to Trustee an invoice for such Ordinary Expenses and depreciation/amortization not later than 30 days after the Interim Period Expiration Date. Trustee shall reimburse UES (or cause UES to be reimbursed) for the amount of such Ordinary Expenses and depreciation/amortization not later than 10 days after its receipt of such invoice from UES; provided however that notwithstanding the foregoing, UES may submit an invoice for such Ordinary Expenses relating to direct Employee costs once every two weeks during the Interim Period and Trustee shall reimburse UES (or cause UES to be reimbursed) for the amount of such direct Employee costs not later than five business days after its receipt of such invoice.

(iii) Except as provided in Section 2.4(b) (if that Section becomes operative), Trustee shall have no responsibility to UES for reimbursement of, or in any other way be liable for, any Ordinary Expenses, depreciation, or amortization that are Accrued by UES after the Interim Period. Trustee shall have no responsibility to UES for reimbursement of any Extraordinary Expenses that are Accrued at any time.

ARTICLE 2
PURCHASE AND SALE OF ASSETS

2.1 **Assets to be Purchased and Sold**. The assets of UES to be purchased and sold pursuant to this Agreement, subject to UES's repurchase obligation pursuant to Section 2.5, are all of the Servicing Function Assets and any of the Other Assets designated by BofA in writing on or prior to the Interim Closing Date or the Final Closing Date, as the case may be. Schedule 2.1, Part I sets forth a list of all of the Servicing Function Assets, and Schedule 2.1, Part II sets forth a list of all of the Other Assets. Such lists contained in Schedule 2.1 shall be deemed to include all assets of UES of each class listed whether or not any particular asset is described with particularity in Schedule 2.1, unless UES has reserved to itself by specific description on Schedule 2.2 any asset(s) there identified with particularity. The Purchased Assets are the following:

(a) **Fixed Assets and Tangible Personal Property**. All fixed assets and tangible personal property of UES used primarily in the Servicing Function, including without limitation computers, telephone equipment, other equipment, machinery, furniture, fixtures, and leasehold improvements (the **"Equipment"**);

(b) **Equipment Leases**. All of UES's right, title, and interest as lessee under leases relating to tangible personal property used primarily in the Servicing Function (the **"Equipment Leases"**);

(c) **Intangible Property**. All of UES's right, title, and interest as owner, lessee, licensee (as the case may be), or otherwise in standard or custom computer software (including without limitation systems, subsystems, and programs), technology, flow charts, algorithms, formulae, know-how, trade secrets, processes, policies, and procedures that relate primarily to the Servicing Function (the **"Intangible Property"**);

(d) **Documents, Records, and Data**. All databases, information, training and user documentation, files, books, records (including without limitation personnel records that may be transferred in accordance with applicable law, all reports and other written materials submitted by UES to the United States Department of Education, the Higher Education Assistance Foundation, or any Guarantors or Insurers (each as defined in the UES Servicing Agreement) since January 1, 1985, and all other records relating to the Student Loans), contracts, manuals, lists, telephone numbers, plans, specifications, and drawings, whether prepared by UES or any of its Affiliates, agents, consultants, or contractors, all whether or not reduced to physical form, acquired for, used in, or in any other way relating primarily to the Servicing Function (the "**Records**");

(e) **Real Property Lease**. All of UES's right, title, and interest as lessee under that certain lease of real property in and on which the Servicing Function is performed (the "**Lease**");

(f) **Contract Rights**. All of UES's contract rights relating primarily to the Servicing Function ("**Contracts**"), including without limitation contracts, orders, licenses or other agreements to which UES is a party or by which UES is bound and pursuant to which any party other than UES may use or otherwise exercise any rights in UES's Intangible Property, purchase orders, rights to purchase, rights to discounts, maintenance agreements, customer contracts, commitments, and all other oral or written understandings and arrangements relating primarily to the Servicing Function, including without limitation the right to receive payments thereunder; but excluding all of UES's accounts receivable. A list of the Contract Rights as of the date hereof is included in the Disclosure Schedule, showing for each contract the names of the parties and the type of product or service or other general description;

(g) **Additional Assets**. Any and all other assets and properties of UES of every kind, character, and description, whether tangible or intangible, real or personal or mixed, and wherever located or by whomever possessed, used by UES primarily in the Servicing Function, including without limitation any interest or interests of UES in any patents and applications therefor, inventories of forms existing as of the Interim Closing Date (whether or not imprinted with trademarks, service marks, trade names, or service names of UES), maintenance operations, rights and claims to refunds (but excluding insurance claims arising on or before the Interim Closing Date), prepaid expenses, customer deposits, deposits by UES with any other person representing collections resulting from performance of the Servicing Function, policies and procedures, discounts and adjustments of any kind, causes of action against agents, consultants, contractors, or other persons acting for on on behalf of UES in connection with the Servicing Function (but excluding causes of action against Peat Marwick Main & Co.), and express or implied warranties, all whether reduced to physical form or otherwise acquired for, used in, or in any other way related primarily to the Servicing Function; and

(h) **Other Assets**. All of the assets described in the preceding clauses (a) through (g) that would constitute Other Assets if not used primarily in the Servicing Function and that have been designated in writing by BofA as Purchased

Assets pursuant to Section 2.3(a) or Section 2.3(b), as the case may be.

2.2 **Assets Not Purchased**. Notwithstanding Section 2.1, UES shall not sell, and BofA shall not acquire any interest in, (a) any of UES's assets not used at all in the Servicing Function, and (b) any of the Other Assets not selected for purchase by BofA pursuant to Section 2.3(a) or Section 2.3(b) (collectively the **"Excluded Assets"**). The **"Excluded Assets"** shall also include all trademarks, service marks, trade names, and service names of UES, and except to the extent comprising Additional Assets described in Section 2.1(g), BofA and Trustee disclaim any right to use such trademarks, service marks, trade names, and service names. All of the Excluded Assets are listed on Schedule 2.2. The Excluded Assets shall remain the property of UES and neither BofA nor Trustee shall have any liability or other responsibility with respect thereto. UES shall promptly remove all Excluded Assets from the property covered by the Lease and do so without damaging such property or unreasonably disrupting the Servicing Function.

2.3 **Transfers of Assets**. On the terms and subject to the conditions set forth in this Agreement, UES shall sell, convey, and assign (or lease/sublease or license/sublicense, as the case may be) and shall transfer and deliver (collectively **"Transfer"**) the Purchased Assets to BofA as provided in this Section 2.3.

(a) **Transfers on Interim Closing Date**. To the extent it may lawfully do so without first obtaining governmental or third-party consents, on the Interim Closing Date UES shall Transfer to BofA, and BofA shall purchase from UES, all of UES's right, title, and interest in and to (i) the Servicing Function Assets and (ii) the Other Assets designated in writing by BofA. On the Interim Closing Date, UES shall deliver to BofA a bill of sale in the form attached as Exhibit 2.3(a) together with such other assignments, leases/subleases, licenses/sublicenses, and other documents of conveyance as are reasonably necessary or appropriate to evidence and effect such Transfer. Simultaneously with such deliveries, UES shall take such steps as are necessary or appropriate to put BofA or the New Servicer in actual possession and operating control of the Servicing Function Assets and the Other Assets, whether or not then Transferred.

(b) **Transfers on Final Closing Date**. On the Final Closing Date, UES shall Transfer to BofA, and BofA shall purchase from UES, all of UES's right, title, and interest in and to (i) all Servicing Function Assets and (ii) the Other Assets designated by BofA pursuant to Section 2.3(a), in each case to the extent not Transferred on the Interim Closing Date. On the Final Closing Date, UES shall execute and deliver to BofA a bill of sale in the form attached as Exhibit 2.3(a) together with such other assignments, leases/subleases, licenses/sublicenses, and other documents of conveyance as are reasonably necessary or appropriate to evidence and effect such Transfer. On the Final Closing Date, BofA shall pay to UES 75% of the Purchase Price.

2.4 Purchase Price; Expenses after Interim Period Expiration Date.

(a) Purchase Price. The full purchase price (the "Purchase Price") for the Purchased Assets shall consist of:

(i) a dollar amount equal to (A) the Book Value of the Equipment as of the Interim Closing Date, minus (B) the Book Value as of the Final Closing Date of any Equipment required to be repurchased by UES on the Final Closing Date pursuant to Section 2.5;

(ii) a dollar amount equal to UES's prepaid expenses as of the Final Closing Date to the extent such prepaid expenses relate to Purchased Assets (other than Purchased Assets required to be repurchased by UES on the Final Closing Date pursuant to Section 2.5); and

(iii) a dollar amount equal to UES's aggregate payment obligations under the Equipment Leases, the Contracts, and the Lease accruing from and after the Interim Closing Date to (but excluding) the Final Closing Date (with respect to the portion of the Purchase Price payable on the Final Closing Date), or to (but excluding) the Repurchase Date (with respect to the portion of the Purchase Price payable on the Repurchase Date).

(b) Expenses.

(i) Subject to Section 2.4(b)(iii), Trustee shall reimburse UES (or cause UES to be reimbursed) for all Ordinary Expenses that are Accrued for the account of UES in connection with the Servicing Function from the Interim Period Expiration Date to but excluding the Final Expiration Date, including without limitation direct Employee costs (such as salaries, wages, and obligatory employee benefits and government payments, but excluding discretionary employee benefits unless otherwise agreed in writing).

(ii) UES shall submit to Trustee an invoice for such Ordinary Expenses not later than 30 days after the Final Expiration Date. Trustee shall reimburse UES (or cause UES to be reimbursed) for the amount of such Ordinary Expenses not later than 10 days after its receipt of such invoice from UES; provided however that, subject to Section 2.4(b)(iii), UES may submit an invoice for such Ordinary Expenses relating to direct Employee costs once every two weeks between the Interim Period Expiration Date and the Final Expiration Date, and Trustee shall reimburse UES for the amount of such direct

Employee costs not later than five business days after its receipt of such invoice.

(iii) As to any Employee who has been specifically designated by Trustee from time to time between the Interim Closing Date and the Final Expiration Date as either (A) a person whom Trustee or the New Servicer desires to hire or (B) a person whom Trustee or the New Servicer does not desire to hire, Trustee shall have no further responsibility to UES for reimbursement of, or in any other way be liable for, any direct Employee costs or other expenses directly or indirectly related to such Employee from and after the date that is two business days following the Designation Date (as defined in Section 8.5) of such Employee. Neither BofA nor Trustee shall have any responsibility to UES for reimbursement of, or in any other way be liable for, any Ordinary Expenses that are Accrued by UES after the Final Expiration Date, and neither BofA nor Trustee shall have any responsibility to UES for reimbursement of any Extraordinary Expenses that are Accrued at any time.

2.5 **Repurchase of Certain Assets**. On the Final Closing Date and on the Repurchase Date, BofA shall Transfer to UES, and UES shall purchase from BofA, all of BofA's right, title, and interest in and to all of the Eligible Repurchase Assets that are designated in writing by BofA in its sole discretion on or prior to either such Date. On the Final Closing Date or the Repurchase Date, as the case may be, BofA shall execute and deliver to UES a bill of sale in the form attached as Exhibit 2.3(a) together with such assignments, terminations of leases, subleases, licenses and sublicenses, and other documents of conveyance as are reasonably necessary or appropriate to evidence and effect such Transfer. In consideration of such Transfer, UES shall, on the Final Closing Date or the Repurchase Date, as the case may be, (i) pay to BofA a dollar amount equal to the Book Value as of the Final Closing Date or the Repurchase Date, as the case may be, of any Equipment repurchased pursuant to this Section 2.5 and (ii) execute and deliver to BofA such instruments of assumption and release as may be reasonably necessary or appropriate to evidence or effect the discharge of any further obligation of BofA as of the Final Closing Date or the Repurchase Date, as the case may be, with respect to any obligation or liability of UES previously assumed by BofA that BofA elects to assign back to UES pursuant to this Section 2.5. On the Repurchase Date, BofA shall pay the balance of the Purchase Price to UES.

2.6 **No Assumption of Obligations by BofA**. BofA shall assume as of the Interim Closing Date or the Final Closing Date (as the case may be) the liabilities comprising a part of the Purchased Assets and identified on Exhibit B to the Bill of Sale in the form attached as Exhibit 2.3. Except as specifically provided in the preceding sentence or in Section 2.3 or Section 2.4, no liabilities or obligations of UES of any nature whatsoever shall be assumed by

BofA. No liabilities or obligations of UES of any nature whatsoever shall be assumed by Trustee.

2.7 Location of Transfers. The Transfers that occur on the Interim Closing Date, the Final Closing Date, and the Repurchase Date shall take place at the offices of Heller, Ehrman, White & McAuliffe, 333 Bush Street, San Francisco, California.

2.8 Payments. All payments to be made under this Agreement shall be made in immediately available funds. No amounts payable by BofA to UES may be offset against the Post-Closing Payment.

2.9 Further Assurances. From time to time after the Final Closing Date, at the request of BofA and without further consideration, UES shall execute and deliver or cause to be executed and delivered, at its expense, such other instruments of transfer as reasonably may be requested by BofA to Transfer more effectively to BofA the right, title, and interest of UES in and to the Purchased Assets and to take or cause to be taken such further or other action as may be necessary or appropriate in order to effect the transactions contemplated by this Agreement.

ARTICLE 3
REPRESENTATIONS AND WARRANTIES OF UES AND UESI

UES and UESI jointly and severally represent and warrant to BofA and Trustee that as of the date of this Agreement, as of the Effective Date, as of the Interim Closing Date, and as of the Final Closing Date:

3.1 Ownership of Assets; Accuracy of Schedule. Except as set forth in the Disclosure Schedule, UES is the true and lawful owner, licensee, or lessee of all of the Servicing Function Assets and all of the Other Assets and has good title thereto and all necessary power and authority to Transfer such Assets to BofA free and clear of all claims, liens, title defects and objections, easements, equities, rights of way, covenants, restrictions, security interests, or other encumbrances, including without limitation leases, chattel mortgages, conditional sales contracts, collateral security arrangements, and other title- or interest-retaining agreements. Schedule 2.1, Part I accurately and completely describes all of the Servicing Function Assets; Schedule 2.1, Part II accurately and completely describes all of the Other Assets.

3.2 Delivery of Assets. Except as set forth in the Disclosure Schedule, upon the Transfer to BofA of the Purchased Assets on the Interim Closing Date or the Final Closing Date (as the case may be), BofA will acquire good and valid title to such Assets free and clear of all claims, liens, title defects and objections, easements, equities, rights of way, covenants, restrictions, security interests, or other encumbrances, including without limitation leases, chattel mortgages, conditional sales contracts, collateral security arrangements, and other title- or interest-retaining arrangements. Neither UES nor UESI, nor any officer, director, employee, shareholder, or creditor of either of them, will have after the Final Closing Date any interest in the Purchased Assets directly or through any other person or entity.

3.3 Organization and Authority. UES and UESI are corporations duly organized, validly existing, and in good standing under the laws of the State of California and the State of Delaware respectively. Each of UES and UESI has full corporate power and authority to own or lease its properties and to carry on its business as it is now being conducted, and is qualified to conduct business as a foreign corporation in all of the jurisdictions in which the nature of the business conducted by UES or UESI (as the case may be), or the character or location of properties UES or UESI (as the case may be) owns or leases, requires such qualification. Neither UES nor UESI has received any claim or notice, formal or otherwise, from any jurisdiction to the effect that it is or was required to qualify to conduct business, or that a jurisdiction in which it is authorized to conduct business may withdraw such authorization. UES and UESI shall promptly deliver to BofA and Trustee true and correct copies of their respective Articles/Certificate of Incorporation as amended, and Bylaws as amended, as in effect on the date of this Agreement. Each of UES and UESI has duly and validly authorized, executed, and delivered this Agreement and all other documents and related actions contemplated by this Agreement. No other corporate proceedings are or will be necessary to authorize the execution, delivery, and performance by UES or UESI of this Agreement or such other documents or actions. This Agreement constitutes the valid, binding, and enforceable obligations of UES and UESI in accordance with its terms.

3.4 Servicing Function Exclusively in UES. UES's conduct in servicing the Student Loans has been performed entirely within UES and not directly or indirectly through UESI or any other corporation, association, partnership, joint venture, or other entity.

3.5 Capitalization. UESI owns beneficially and holds of record all of the outstanding capital stock of UES. UES does not have outstanding any convertible securities, options, warrants, scrip, rights to subscribe, calls, or commitments of any character relating to any of its capital stock.

3.6 Compliance With Law and Other Instruments. The Disclosure Schedule contains complete and correct lists of all material licenses, permits, and authorizations held by UES related to the Servicing Function. Except as shown on the Disclosure Schedule, (a) each of UES and UESI holds and at all times has held all material licenses, permits, and authorizations necessary for

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the lawful conduct of the Servicing Function pursuant to all applicable statutes, laws, ordinances, rules, and regulations of all governmental bodies, agencies, and other authorities having jurisdiction over it or any part of its operations, and (b) there are no material violations or claimed violations by UES or UESI of any such license, permit, or authorization or any such statute, law, ordinance, rule, or regulation, including without limitation any federal, state, or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment, or which have been enacted or adopted for the protection of employees or equal employment opportunities. Each of UES and UESI has obtained all material consents, approvals, waivers, orders, and authorizations from, and made all material registrations, qualifications, designations, declarations, and filings with, any federal, state, local, or foreign governmental authority, relating to it required in connection with this Agreement or the consummation of the transactions contemplated by this Agreement. Except as set forth in the Disclosure Schedule or to the extent not material, neither the execution and delivery of this Agreement by the UES or UESI, nor the performance by either of them of any of its obligations under this Agreement, will violate any provision of law or any decree or order of any governmental body or will conflict with, result in the breach of any of the terms or conditions of, constitute a default under, permit any party to accelerate any rights under or terminate, or result in the creation of any lien, charge, or encumbrance upon any of the Servicing Function Assets or Other Assets pursuant to, any charter document or any agreement, indenture, mortgage, lease, franchise, license, permit, authorization, or other instrument of any kind to which either of them is a party or by which either of them or any of the Servicing Function Assets or Other Assets is bound or affected. Notwithstanding anything else contained in this Section 3.6, UES and UESI make no representation or warranty with respect to compliance with the Higher Education Act and the rules and regulations of the Department of Education thereunder in connection with the conduct of UES in servicing student loans.

3.7 Financial Statements. Attached to the Disclosure Schedule are (a) the audited consolidated financial statements of UESI as at and for the fiscal year ended January 31, 1988, together with the related audit reports of Peat Marwick Main & Co., (b) the unaudited consolidated and consolidating financial statements of UESI as at and for the seven months ended August 31, 1988, (c) the unaudited consolidating financial statements of UESI as at and for the fiscal year ended January 31, 1988, (d) the unaudited consolidated statements of sources and uses of cash of UESI for the seven months ended August 31, 1988 and for the month of August 1988, and (e) a statement of intercompany transfers reflecting any such transfers made during each of the months from February 1, 1988 through August 31, 1988 inclusive, together with certificates of accuracy and completeness signed by the President and Chief Financial Officer of UES and/or UESI (as the case may be) for all such financial statements described in clauses (b), (c), (d), and (e). Such financial statements are referred to collectively as the "**Financial Statements**", and (except as provided in the following sentence) contain true, complete, and correct balance sheets, statements of income/loss, and statements of changes in financial position. The Financial Statements (together with the notes thereto where applicable) (x) are in accordance with the books and records of UES and UESI, (y) present fairly the financial position of UES and UESI as at, and for the periods ending on, the dates indicated (subject to adjustments of the type normally made at year end, to overstatements/understatements of total assets not exceeding 10% of the amounts shown, to overstatements/understatements of total liabilities not exceeding 10% of the aggregate liabilities shown, to overstatements/understatements of shareholders' equity not exceeding 10% of the amounts shown, to overstatements/understatements of revenue not exceeding $500,000, to overstatements/understatements of net income not exceeding $500,000, and to variances in any other item that are not material when considered in light of the Financial Statements taken as a whole, and excluding the effect on the Financial Statements of the transactions contemplated by this Agreement), and (z) have been prepared in accordance with GAAP (except that the separately stated Financial Statements do not reflect proper consolidation).

3.8 **Absence of Undisclosed Liabilities**. Except as set forth in the Disclosure Schedule, as of August 31, 1988, neither UES nor UESI had any known indebtedness or liability (absolute or contingent) that is not shown on or provided for in the Financial Statements. Except as shown in the Financial Statements or in the Disclosure Schedule, as of the date of this Agreement neither UES nor UESI has, and neither of them will have on the Effective Date, the Interim Closing Date, or the Final Closing Date, any additional known indebtedness or liability (absolute or contingent) other than those incurred since August 31, 1988 in the ordinary course of business or in connection with this Agreement, none of which is or will be materially adverse to the financial position, assets, or results of operations or business of either of them. To the best knowledge of each of UES and UESI, there are no circumstances existing that could reasonably be expected to give rise to any basis for an assertion against either of them of any such liability or any such other loss contingency in any amount not fully reflected or reserved against in the Financial Statements. The Disclosure Schedule also contains a list, description, and explanation of items and corresponding amounts of any and all un-Accrued liabilities existing as of the date hereof for payments to be made or costs to be incurred by UES or UESI after the date hereof other than normal recurring charges in the ordinary course of business or except as otherwise specifically set forth or described in the Disclosure Schedule.

3.9 **Tax Returns and Payments.**

(a) All United States federal, state, local, and foreign tax returns (including any information returns), declarations of estimated tax, and tax reports required to be filed with respect to UES, UESI, or any of the income, properties, franchises, or operations of either of them have been duly and timely filed or adequate extensions have been secured. Except as set forth in the Disclosure Schedule, all United States federal, state, local, and foreign taxes shown on such returns (including any interest and penalties thereon) and deficiencies (including any interest and penalties thereon) assessed against UES or UESI have been paid to the appropriate tax-collecting authority by the taxpayer that is or was liable therefor, to the extent that such taxes have become due. The liability (if any) for all United States federal, state, local, and foreign taxes that are not yet due and that are required to be accrued under GAAP have been Accrued on the books of UES and/or UESI (as the case may be) and is either reflected in the Financial Statements or (to the extent accrued after August 31, 1988) is set forth in the Disclosure Schedule.

(b) Except as set forth in the Disclosure Schedule, there are no reviews pending or any basis for any additional assessment by the Internal Revenue Service or by the tax-collecting authority of any other jurisdiction, foreign or domestic, with respect to the income, properties, franchises, or operations of UES or UESI for any fiscal period for which adequate reserves have not been provided for in the Financial Statements.

3.10 Absence of Certain Changes and Events. Except as set forth in the Disclosure Schedule, since August 31, 1988 there has not been:

(a) Any transaction entered into by UES or UESI other than in the ordinary course of business; any change in the financial position, assets, liabilities, results of operations, or business of UES or UESI other than changes in the ordinary course of business that in the aggregate have not had a materially adverse effect on the assets of UES or UESI (as the case may be); or, without limiting the foregoing, any loss or damage to any of the properties or assets of UES or UESI due to fire or other casualty, or any other loss, whether or not insured, amounting to more than $25,000 in the aggregate;

(b) Any increase in the compensation or rate of compensation payable or to become payable by UES or UESI to any director, officer, employee, agent, or consultant, other than increases in the ordinary course of business consistent with past practice, or any bonus, percentage compensation, service award, or other benefit granted, made, or accrued to or to the credit of any such person, or any welfare, pension, severance, retirement, or similar payment or arrangement made or agreed to by UES or UESI;

(c) Any discharge or satisfaction by UES or UESI of any lien or encumbrance, or any payment of any obligation or

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liability (absolute or contingent), other than current liabilities shown on the Financial Statements and current liabilities incurred in the ordinary course of business since August 31, 1988, or any incurrence or agreement to incur or become subject to any obligations or liability; or

(d) Any mortgage, pledge, or imposition of any security interest, claim, encumbrance, or other restriction on any assets of UES or UESI.

3.11 Interests in Real Property. Except as set forth in the Disclosure Schedule, neither UES nor UESI owns any real property related to the Servicing Function. Correct and complete copies of the Lease and all other leases respecting real property of which UES or UESI is a lessee in connection with the Servicing Function, including all amendments thereto, have been delivered to BofA and Trustee. The Disclosure Schedule contains a complete and correct list and brief description of any oral modifications or other departures from the written terms of such leases. All of such leases are valid and enforceable. UES or UESI (as the case may be) is in material compliance with, and is not in material default in performance of, any of such leases, and to the best knowledge of UES and UESI, no other party to any of such leases is not in compliance with, or is in default in performance of, a material provision thereof. None of the transactions contemplated by this Agreement will result in a default under any of such leases or permit the lessor to terminate any such leases or increase the rent or any other charges payable by the lessee thereunder. Neither UES nor UESI is a party to, or is negotiating in respect of, any other lease or other agreement relating to real property in connection with the Servicing Function. Except as set forth in the Disclosure Schedule, all real property leased by UES or UESI and related to the Servicing Function is free and clear of all easements, reservations, rights-of-way, liens, encumbrances, and restrictions that could affect its ability to use such property. All improvements and fixtures on real properties leased by UES and UESI related to the Servicing Function conform in all material respects to all applicable health, fire, safety, pollution, zoning, and building laws and ordinances, and except as set forth in the Disclosure Schedule, all buildings, structures, and fixtures used by UES or UESI in the conduct of its business related to the Servicing Function are in good operating condition and repair.

3.12 Personal Property. Schedule 2.1 contains a complete and correct list of the Equipment. Except as set forth in the Disclosure Schedule, UES has good and marketable title, free and clear of all title defects, security interests, pledges, options, claims, liens, encumbrances, and restrictions of any nature whatsoever (including without limitation leases, chattel mortgages, conditional sale contracts, collateral security arrangements, and other title- or interest-retaining agreements) to the Equipment. Correct and complete copies of all of the Equipment Leases, including all amendments thereto, shall be promptly delivered to BofA and Trustee. The Disclosure Schedule includes a complete and correct list and brief description of all oral modifications or other departures from the written terms of the Equipment Leases. All of the Equipment Leases are valid and enforceable. UES is in material compliance with, and is not in material default in performance of, any of the Equipment Leases and no other party to any of the Equipment Leases is not in compliance with, or is in default in performance of, any material provision thereof. Except as set forth in the Disclosure Schedule, none of the transactions contemplated by this Agreement will result in a default under any of the Equipment Leases or permit the lessor to terminate any of the Equipment Leases or increase the rent or any other charges payable by the lessee thereunder. Except as set forth in the Disclosure Schedule or to the extent not material, all Equipment used by UES in the conduct of its business is in good operating condition and repair.

3.13 **Transferability of Assets**. Except as set forth in the Disclosure Schedule, UES has the right to assign its rights under or in all the Servicing Function Assets and Other Assets, in each case without the necessity of obtaining consent to such assignment from any other party or parties. Subject to the UES's obtaining required consents as set forth in the Disclosure Schedule, neither the assignment of such rights nor the consummation of the transactions contemplated by this Agreement would lead any party with which UES has contractual relations to terminate or alter such contractual relations.

3.14 **Property to Operate Business**. The Servicing Function Assets and the Other Assets constitute in all material respects all the property used in whole or in part in the Servicing Function as it is presently being conducted.

3.15 **Certain Affiliate Transactions**. Except as set forth on the Disclosure Schedule, no officer, director, or holder directly or indirectly of not less than 5% beneficial interest of UES or UESI is presently or has been since February 1, 1988 a party directly or indirectly to any transaction involving either of UES or UESI that has/had a value in excess of $10,000 as to any particular such transaction or in excess of $100,000 as to all such transactions, including without limitation any such transaction relating to (a) the furnishing of services (other than as a director, officer, employee, agent, or consultant), (b) the rental or sale of real or personal property, (c) loans or guarantees, or (d) otherwise requiring any payments to or by either of UES or UESI. UES and UESI have caused to be delivered to BofA and Trustee true and correct copies of all agreements and other documents relating to any such transactions.

3.16 **Intangible Property**.

(a) Schedule 2.1 contains a complete and correct list of the Intangible Property.

(b) UES has paid any and all fees, taxes, charges or other sums and has made any and all filings, declarations, or registrations with any United States governmental authorities and with governmental authorities in any other jurisdiction, necessary to maintain the validity, existence, and enforceability of the Intangible Property.

(c) Except to the extent described in the Disclosure Schedule:

(i) no litigation related to the Servicing Function is pending or (to the best knowledge of UES and UESI) threatened against UES for the infringement of any patent, trademark, service mark, trade name, service name, or copyright or for the misuse or misappropriation of any trade secret or know-how;

(ii) to the best knowledge of UES and UESI, neither UES nor UESI has engaged or is engaging in actions related to the Servicing Function constituting or resulting in the infringement or unauthorized use of any patent, trademark, service mark, trade name, service name, copyright, process, design, formula, invention, trade secret, know-how, or technology belonging to any third party; and

(iii) to the best knowledge of UES and UESI, there is no infringement or unauthorized use by any third party of any of the Intangible Property.

3.17 License Agreements. Complete and correct copies of all license agreements related to the Servicing Function, including all amendments thereto, to which UES is a party, have been delivered to BofA and Trustee and are incorporated herein. All such license agreements are valid and enforceable against all parties thereto. UES is in material compliance with, and is not in material default in performance of, such license agreements, and to the best knowledge of UES and UESI, no other party to any such license agreement is not in compliance with, or is in default in performance of, any material provision thereof. UES and UESI have no knowledge that any other party to any such license agreement intends or contemplates the termination of such license agreement. No such license agreement purports to grant the licensee thereunder any greater rights than the licensor was (at the time of the licensor's execution thereof) and is empowered to grant, or conflicts in any way with the provisions of any other license agreement or other agreement to which UES is a party. No such license agreement or any other agreement to which UES is a party contains any noncompetition, confidentiality, or other provision in any way limiting the conduct of the business of the UES following termination thereof.

3.18 Agency Agreements. The Disclosure Schedule contains a complete and correct list of all agency agreements related to the

Servicing Function to which UES is party. Complete and correct copies of all such agency agreements, including all amendments thereto, have been delivered to BofA and Trustee. UES is in material compliance with, and is not in material default in performance of, any such agency agreements, and to the best knowledge of UES and UESI, no other party to any of such agency agreements is not in compliance with, or in default in performance of, any material provision thereof. No such agency agreement grants any person or entity the exclusive right to act, or otherwise binds UES to use any person or entity to any extent, as agent of UES for any purpose. No such agency agreement grants any person or entity the right to enter into any contract on behalf of UES without express written instructions of UES. Each such agency agreement is terminable by UES at any time and without cause, except as otherwise set forth in the Disclosure Schedule.

3.19 Litigation and Other Proceedings. Except as set forth in the Disclosure Schedule, neither UES, UESI, nor any of their respective directors, officers, or shareholders is a party to any material pending or (to the best knowledge of UES and UESI) threatened action, suit, proceeding, labor proceeding (including any union representation proceeding), or investigation in or by any court or governmental board, commission, agency, department, or office or any arbitrator in the United States or elsewhere, arising or claimed to arise from actions or inactions of UES or UESI or (in the case of an individual) from actions or inactions in his capacity as a director, officer, or shareholder of UES or UESI. The Disclosure Schedule contains a complete and correct description of each such pending action or proceeding, including the names of the parties and their counsel, the identity of the court or other forum, the claims therein, and the current status. Neither UES nor UESI is subject to any order, writ, judgment, decree, or injunction that materially adversely affects or might materially adversely affect its business or assets or that might prevent consummation of the transactions contemplated by this Agreement.

3.20 Contracts. Attached to the Disclosure Schedule are copies of the Lease and all other currently effective contracts (oral or written) (other than the UES Servicing Agreement, and the license agreements and the agency agreements described in Sections 3.17 and 3.18) related to the Servicing Function by which UES or UESI or any of their respective properties or assets is bound or affected that (a) involve the payment or receipt by UES or UESI (as the case may be) of, or involve delivery of assets, goods, services, or commodities having a value of, more than $500; or (b) have a duration of 90 days or more. Neither UES nor UESI is not in material compliance with, or is in material default in performance of, any of such contracts, and to the best knowledge of UES and UESI, no other party to any such contract is not in compliance with, or is in the default in performance of, a material provision thereof.

3.21 **Credit Agreements**. The Disclosure Statement contains a complete and correct list of all loan agreements, promissory notes, letters of credit, security agreements, or other financing documents to which UES or UESI is a party or by which either of them or their respective properties or assets are bound or affected that require the consent of any other person for UES or UESI to enter into this Agreement or to consummate the transactions contemplated hereby, together with a description of the term and amount owing in respect thereof. UES or UESI (as the case may be) is in material compliance with, and is not in material default in performance of, any such contracts, and to the best knowledge of UES and UESI, no other party to any such contract is not in compliance with, or is in default in performance of, a material provision thereof. True and complete copies of all such contracts, including all amendments thereto, have been delivered to BofA and Trustee.

3.22 **Banking Facilities**. The Disclosure Schedule contains a complete and correct list of the names and locations of all banks in which UES or UESI has accounts related to the Servicing Function, the designation of each such account, and the names of all persons authorized to draw on each such account.

3.23 **Personnel; ERISA**. To the extent related to the Servicing Function, the Disclosure Schedule contains a complete and correct list and description, and complete and correct copies shall be delivered to BofA or Trustee upon the request of either of them, of (a) all employment, bonus, profit sharing, deferred compensation, commission, insurance, fringe benefit, severance, termination, pension, and retirement agreements, plans, programs, policies, and arrangements (whether written or oral) respecting or affecting any directors, officers, Employees, agents, or consultants to which UES is a party or by which UES or any of its assets or properties is bound or affected or which could result in any claim in connection with termination of employment of any such person before or after the Closing; (b) the names and current salary rates of all officers of UES; (c) the names and compensation rates of every person whose total annual compensation from the UES is greater than $50,000; and (d) the wage rates or range of rates for the UES's non-salaried Employees. UES is not in default with respect to any of its obligations so listed or required to be listed, and UES has established adequate reserves on its books for such obligations. All written employment contracts involving any of the Employees are listed in the Disclosure Schedule. The Disclosure Schedule contains a complete and accurate list of all earned and unpaid bonuses or incentive payments payable (whether or not subject to contingencies in employment agreements or otherwise) to Employees as of the date of this Agreement, the current amount of accrued vacation and sick leave for such Employees, and the amount currently accrued or payable to such Employees under other fringe benefit plans (other than such plans with benefits that are completely funded by currently-effective insurance policies as to which all current premiums have been fully and timely paid by UES), showing each Employee's name and the applicable amounts. Except as set forth in the Disclosure Schedule, there are no pending or (to the best knowledge of UES or UESI) threatened lawsuits, disputes, controversies, administrative actions, charges, or proceedings of any kind by or with Employees or former employees of UES. None of the Employees are represented by labor unions with respect to UES, and to the best knowledge of UES and UESI, there are no campaigns or proposals by any union to represent any of the Employees with respect to UES. UES, and all "employee benefit plans" (as defined in Section 3(3) of ERISA) that cover one or more of the Employees, are in material compliance with all laws, regulations, and reporting, disclosure, and other requirements applicable to such plan. Except as described in the Disclosure Schedule, complete copies of all the most recent summary plan descriptions, any summary of material modifications, the five most recent annual reports (including any schedules) and, where applicable, the three most recent actuarial reports, the most recent Internal Revenue Service determination letters and any pending determination letter applications, trust agreements, investment management agreements, and insurance contracts or policies relating to all such employee benefit plans have been delivered to BofA and Trustee. UES has not incurred and does not expect to incur any liability to the Pension Benefit Guaranty Corporation ("PBGC") or to the Internal Revenue Service with respect to any such employee benefit plan, and no proceeding or other action has been initiated by the PBGC to terminate any such plan or any written notice given of an intention to commence or seek the commencement of any such proceeding or action.

3.24 Governmental Consents. The Disclosure Schedule contains a complete and correct list of all consents, approvals, orders, and authorizations from, and all registrations, qualifications, designations, declarations, and filings with, any federal, state, local, or foreign governmental authority required of UES or UESI in connection with this Agreement or the consummation of the transactions contemplated hereby.

3.25 Certain Payments. To the best knowledge of the Senior Management of UES and UESI, neither of them nor any person or other entity has directly or indirectly on behalf of or with respect to either of them or their respective businesses or operations, to the extent such businesses or operations concern the Servicing Function, (a) knowingly made or received any payment that was not legal to make or receive under federal, state, or local laws of the United States or any other country or territory having jurisdiction over either of them; (b) knowingly engaged in any transaction or made or received any payment that was not properly recorded on the books of UES or UESI (as the case may be) in accordance with GAAP and all applicable laws; or (c) knowingly created or used any "off-book" account or fund. Neither UES nor UESI has participated directly or indirectly, on behalf of itself or the other or any third party, in any boycotts or similar practices.

3.26 **Environmental Conditions**. To the knowledge of the Senior Management of UES and UESI, there are no conditions presently or potentially posing a significant hazard to human health or the environment, whether or not in compliance with law, existing on the real property covered by the Lease or any other real property related to the Servicing Function presently or previously owned, owned, leased, operated, or controlled by UES or its predecessors, and there has been no production, use, presence, treatment, storage, transportation, disposal, release, or threatened release of any Hazardous Substance or Hazardous Waste (as hereinafter defined) at any such real property. To the knowledge of the Senior Management of UES and UESI, there has been no disposal at any site currently listed pursuant to 42 U.S.C. Section 9605(8)(B) (or pursuant to any similar state law identifying hazardous sites) or any site currently being investigated for such listing pursuant to any such law, of any Hazardous Waste or Hazardous Substance by UES or its predecessors. **"Hazardous Waste"** and **"Hazardous Substance"** shall have the meanings set forth in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, 42 U.S.C. §§ 9601 et seq. (**"CERCLA"**) and the Resource Conservation and Recovery Act, as amended, 42 U.S.C. §§ 6901 et seq., and the regulations adopted pursuant thereto, except that the term **"Hazardous Substance"** as used herein shall, in addition to its definition under CERCLA, also include petroleum, petroleum products, and any substance classified as "hazardous" under an applicable state law or regulation.

3.27 **Post-Transfer Status**. The Transfer of the Assets to BofA will not render UES or UESI insolvent or unable to pay its respective debts, liabilities, and obligations as such debts, liabilities, and obligations become absolute and matured. The property remaining in UES's ownership and control after the Transfer of the Assets will be sufficient to permit UES to carry on business.

3.28 **No Extraordinary Expenses**. Since August 31, 1988, neither UES nor UESI has incurred any Extraordinary Expenses except as set forth in the Disclosure Schedule.

3.29 **No Action to Threaten Status of Student Loans**. To the best knowledge of the Senior Management of UES and UESI, no officer, director, employee, consultant, or agent of UES has made a statement of material fact relating to a Student Loan that was (at the time made) known by Senior Management of UES or UESI to be false, or (at the time made) known by Senior Management to have omitted a material fact necessary to make statements made not misleading, the effect of which could reasonably have been anticipated to have the effect of threatening the Insurance, Guaranty status, Interest Subsidies, or Special Allowance Payments (each as defined in the UES Servicing Agreement) relating to any Student Loan.

3.30 No Assignment of UES Service Agreement. UES has not assigned any of its rights or obligations under the UES Servicing Agreement.

3.31 No Assignment of Released Claims. Neither UES nor UESI has assigned in whole or in part any of the claims that, if not so assigned, would be released in Section 9.2(c).

3.32 No Other E&O Policy; No D&O Policy. Except for the E&O Policy (the existence and effectiveness of which UES and UESI do not warrant), neither UES nor UESI currently has in effect any errors and omissions insurance policy or other insurance or indemnity arrangement however designated which provides coverage against errors and omissions of the type covered by the form of E&O Policy, nor has either of them ever had such a policy or arrangement as to which any claim of errors or omissions of the type covered by the form of E&O Policy might currently be made against UES or UESI by BofA or Trustee (in its own behalf or in behalf of the Letter of Credit Banks) with respect to any of such claims released by BofA and Trustee (in its own behalf and in behalf of the Letter of Credit Banks) in Section 9.2(a) but for such release. Neither UES nor UESI currently has in effect any directors and officers liability insurance policy or other insurance or indemnity arrangement however designated which provides coverage of the type customarily covered by a directors and officers liability insurance policy, nor has either of them ever had such a policy or arrangement as to which any claim of the type customarily covered by a directors and officers liability insurance policy might currently be made with respect to any of such claims released by BofA and Trustee (in its own behalf and in behalf of the Letter of Credit Banks) in Section 9.2(a) but for such release.

3.33 Accuracy of Documents and Information. All instruments, agreements, other documents, and written information delivered or to be delivered to BofA or Trustee or their respective representatives hereunder, including but not limited to the Disclosure Schedule, are and will be complete and correct in all material respects as of the date of this Agreement, as of the Effective Date, as of the Interim Closing Date, and as of the Final Closing Date. The representations and warranties made by UES and UESI in this Agreement do not and will not contain any untrue statement of a material fact, or omit or will omit a material fact necessary to make the statements or facts contained herein or therein, in light of the circumstances under which they are made, not misleading. To the best knowledge of UES and UESI, there is no fact that materially and adversely affects the financial position, assets, liabilities, results of operations, business, or prospects of UES or UESI that has not been expressly and fully set forth in this Agreement.

ARTICLE 4
REPRESENTATIONS AND WARRANTIES OF BofA AND TRUSTEE

As of the date of this Agreement, as of the Effective Date, as of the Interim Closing Date, and as of the Final Closing Date:

4.1 Organization. Each of BofA and Trustee represents and warrants to UES and UESI that BofA is a duly organized and validly existing national trust and savings association.

4.2 Authorization. BofA represents and warrants to UES and UESI that BofA has duly and validly authorized, executed, and delivered this Agreement, and that this Agreement constitutes the valid and binding obligation of BofA, enforceable against BofA in accordance with its terms. Trustee represents and warrants to UES and UESI that Trustee has duly and validly authorized, executed, and delivered this Agreement, and that this Agreement constitutes the valid and binding obligation of Trustee, enforceable against Trustee in accordance with its terms.

4.3 Governmental Consents. BofA represents and warrants to UES and UESI that no consents, approvals, orders, or authorizations from, or registrations, qualifications, designations, declarations, or filings with, any federal, state, local, or foreign governmental authority are required of BofA in connection with this Agreement or the consummation of the transactions contemplated hereby. Trustee represents and warrants to UES and UESI that no consents, approvals, orders, or authorizations from, or registrations, qualifications, designations, declarations, or filings with, any federal, state, local, or foreign governmental authority are required of Trustee in connection with this Agreement or the consummation of the transactions contemplated hereby.

4.4 No Assignment of UES Service Agreement. Trustee represents and warrants to UES and UESI that except in connection with the refinancing of debt issued pursuant to any Indenture with the proceeds of debt issued pursuant to another Indenture, Trustee has not assigned any rights of the "Corporation" under the UES Servicing Agreement as contemplated by Section 8(d)(ii) thereof.

4.5 No Assignment of Released Claims. BofA represents and warrants to UES and UESI that BofA has not assigned in whole or in part any of the claims that, if not so assigned, would be released in Section 9.2(a). Trustee represents and warrants to UES and UESI that Trustee has not assigned in whole or in part any of the claims that, if not so assigned, would be released in Section 9.2(a).

4.6 Complete List of Letter of Credit Banks and Indentures. Trustee represents and warrants to UES and UESI that the Letter of Credit Banks identified in the definition thereof are the only persons that have issued letters of credit to support the notes, bonds, and other evidences of indebtedness of CSLFC issued pursuant to the Indentures, and that the Indentures identified in the definition thereof (including the Additional Bank Note Indentures referred to in such definition) are the only indentures relating to the Student Loans that are subject to the Servicing Function.

ARTICLE 5
CONDITIONS TO THE OBLIGATIONS OF BofA AND TRUSTEE

5.1 Interim Closing Date Conditions. Neither BofA nor Trustee shall be obligated to consummate the transactions contemplated by this Agreement to be consummated on the Interim Closing Date unless on the Interim Closing Date each of the following conditions shall either have been satisfied or have been waived in writing by BofA and/or by Trustee (as the case may be, depending on whether the condition is intended to benefit BofA or Trustee or both of them):

(a) Representations and Warranties True. The representations and warranties of UES and UESI contained in this Agreement shall have been true when made and shall be true on and as of the Interim Closing Date as if such representations and warranties were made on the Interim Closing Date other than representations and warranties expressly limited to a different specified date.

(b) Performance of Covenants. All of the covenants required to be performed by UES and UESI at or before the Interim Closing Date pursuant to the terms of this Agreement shall have been duly performed.

(c) Material Changes. Between the date of this Agreement and the Interim Closing Date:

(i) there shall have been no material adverse change in the financial position, results of operations, assets, liabilities, or business of UES or UESI, including without limitation a Bankruptcy;

(ii) neither UES nor UESI shall have been involved in, and no person or entity shall have threatened to involve UES or UESI in, any action, suit, labor dispute (including any union representation proceeding), proceeding, or investigation that materially adversely affects, or might materially adversely affect, the financial position, results of operations, assets, liabilities, or business of UES (including the Servicing Function) or of UESI, nor shall UES or UESI have become party to any collective bargaining agreement;

(iii) no portion of the Servicing Function Assets or Other Assets shall have been destroyed or materially damaged by any cause whatsoever, whether or not insured against; and

(iv) neither UES nor UESI shall have suffered any liability, judgment, lien, or termination of contract, or the imposition of any obligation, the effect of which is or might be materially adverse to the financial position, results of operations, assets, liabilities, or business of UES (including the Servicing Function) or of UESI.

(d) No Action to Prevent Completion. Neither BofA nor Trustee shall have determined that the transactions contemplated by this Agreement have become inadvisable or impractical by reason of the institution or threat of institution, by any federal, state, or local governmental authority or any other person or entity, of litigation or other proceedings with respect to any of the transactions contemplated by this Agreement.

(e) Instruments of Conveyance. UES shall have duly executed and delivered to BofA such bills of sale, assignments, and other instruments of conveyance with respect to the Purchased Assets to be Transferred on the Interim Closing Date, in form and substance acceptable to BofA.

(f) Disclosure Schedule. BofA and Trustee shall have approved the Disclosure Schedule and any amendments and supplements to the Disclosure Schedule necessary to make the Disclosure Schedule accurate and complete on and as of the Interim Closing Date.

(g) Consent from Letter of Credit Banks. Trustee shall have received from the Letter of Credit Banks such consents to the terms of this Agreement and of the New Servicing Agreement, and to the transactions and circumstances contemplated hereby and thereby, as it reasonably deems necessary.

(h) Consent from CSLFC. Trustee shall have received from CSLFC such consent to the terms of this Agreement as Trustee reasonably deems necessary, including without limitation the joinder of CSLFC in the termination of the UES Servicing Agreement pursuant to Section 9.1.

(i) New Servicing Agreement. The New Servicing Agreement shall have been executed by all parties thereto and shall have become effective in accordance with its terms.

(j) Cash Collateral. Trustee shall have received (i) a certificate or certificates evidencing the Cash Collateral, (ii) a written assignment to Trustee of the right to receive the principal balance of the Cash Collateral, in form and substance satisfactory to Trustee, and (iii) evidence satisfactory to Trustee that any depository institution obligated in respect of the Cash Collateral has acknowledged in writing its receipt of written notice of the security interest in the Cash Collateral granted to Trustee as described in Section 7.8(d).

(k) **Evidence of Effective Waiver of Subrogation**. BofA and Trustee shall have received evidence satisfactory to them that the waiver of subrogation rights contained in Section 7.16 is binding upon the insurers of UES.

(l) **Other Actions**. All actions, proceedings, instruments, resolutions, certificates, and documents reasonably requested by BofA or Trustee to be delivered to BofA or Trustee (as the case may be) in order to carry out this Agreement, and all other relevant legal matters, shall be reasonably satisfactory to BofA and its counsel or to Trustee and its counsel (as the case may be).

5.2 **Final Closing Date Conditions**. Neither BofA nor Trustee shall be obligated to consummate the transactions contemplated by this Agreement to be consummated on the Final Closing Date unless at or before the Final Closing Date each of the following conditions shall either have been satisfied or have been waived in writing by BofA and/or by Trustee (as the case may be, depending on whether the condition is intended to benefit BofA or Trustee or both of them). Notwithstanding the foregoing, upon the failure of the Final Closing Date to occur, BofA may nevertheless on the Final Expiration Date require UES to repurchase in accordance with Section 2.5 any or all of the Eligible Repurchase Assets that were Transferred to BofA on the Interim Closing Date.

(a) **Representations and Warranties True**. The representations and warranties of UES and UESI contained in this Agreement shall have been true when made, on the Effective Date, and on the Interim Closing Date, and shall be true on and as of the Final Closing Date as if such representations and warranties were made on the Final Closing Date, other than representations and warranties expressly limited to a different specified date.

(b) **Performance of Covenants**. All of the covenants required to be performed by UES and UESI at or before the Final Closing Date pursuant to the terms of this Agreement shall have been duly performed.

(c) **Certificate**. On the Final Closing Date, BofA and Trustee shall have received a certificate, dated as of the Final Closing Date, signed by the Presidents of each of UES and UESI, to the effect that all of the conditions set forth in Sections 5.2(a) and (b) have been satisfied.

(d) **Material Changes**. Between the Interim Closing Date and the Final Closing Date:

(i) there shall have been no material adverse change in the financial position, results of operations, assets, liabilities, or business of UES or UESI, including without limitation a Bankruptcy;

(ii) neither UES nor UESI shall have been involved in, and no person or entity shall have threatened to involve UES or UESI in, any action, suit, labor dispute (including any union representation proceeding), proceeding, or investigation that materially adversely affects, or might materially adversely affect, the financial position, results of operations, assets, liabilities, or business of UES (including the Servicing Function) or of UESI, nor shall UES or UESI have become party to any collective bargaining agreement;

(iii) no portion of the Purchased Assets shall have been destroyed or materially damaged by any cause whatsoever, whether or not insured against; and

(iv) neither UES nor UESI shall have suffered any liability, judgment, lien, or termination of contract, or the imposition of any obligation, the effect of which is or might be materially adverse to the financial position, results of operations, assets, liabilities, or business of UES (including the Servicing Function) or of UESI.

(e) No Action to Prevent Completion. Neither BofA nor Trustee shall have determined that the transactions contemplated by this Agreement have become inadvisable or impractical by reason of the institution or threat of institution, by any federal, state, or local governmental authority or any other person or entity, of litigation or other proceedings with respect to any of the transactions contemplated by this Agreement.

(f) Good Standing Certificates. UES and UESI shall have furnished BofA and Trustee with good standing certificates and (from jurisdictions where they are issued) tax good standing certificates, dated as near to the Final Closing Date as is practicable.

(g) Transfers of Leases. Each lessor under the Lease and the Equipment Leases (in each case to the extent purchased by BofA) shall have (i) consented in writing to the assumption by BofA of all of UES's rights, interests, and obligations thereunder, (ii) confirmed to BofA in writing the dollar amount of any deposits made by UES for security thereunder, which deposits will be credited to BofA after assignment by UES to BofA of UES's rights, interests, and obligations thereunder, (iii) except with respect to the Lease, acknowledged that BofA's assumption is voidable upon notice given by BofA to such lessor, and (iv) delivered an estoppel certificate to BofA in form and substance reasonably acceptable to BofA.

(h) **Instruments of Conveyance**. UES shall have duly executed and delivered to BofA such bills of sale, assignments, and other instruments of conveyance with respect to the Purchased Assets that are Transferred on the Final Closing Date, in form and substance acceptable to BofA.

(i) **Opinion of Counsel**. BofA and Trustee shall have received the opinion of Baker & McKenzie, counsel to UES and UESI, in form and substance satisfactory to BofA and its counsel and to Trustee and its counsel, dated as of the Final Closing Date, with respect to the matters described in Exhibit 5.2(i) and such other matters as BofA and its counsel, or Trustee and its counsel, may reasonably request.

(j) **Opinion of Bond Counsel**. BofA and Trustee shall have received the opinion of Orrick, Herrington & Sutcliffe, in form and substance satisfactory to BofA and its counsel and to Trustee and its counsel, dated as of the Final Closing Date, with respect to such matters as BofA or Trustee may request.

(k) **Book Value of Assets; Prepaid Expenses**. BofA shall have received certificates from an officer of UES and from Peat Marwick Main & Co., UES's independent certified public accountants, certifying (i) the Book Values of the respective Servicing Function Assets and the respective Other Assets as of the Interim Closing Date, and (ii) the amount of UES's prepaid expenses as at the Final Closing Date, to the extent such prepaid expenses relate to Purchased Assets (other than Purchased Assets required to be repurchased by UES on the Final Closing Date pursuant to Section 2.5).

(l) **Other Actions**. All actions, proceedings, instruments, resolutions, certificates, and documents reasonably requested by BofA or Trustee to be delivered to BofA or to Trustee (as the case may be) in order to carry out this Agreement, and all other relevant legal matters, shall be reasonably satisfactory to BofA and its counsel and to Trustee and its counsel.

ARTICLE 6
CONDITIONS TO THE OBLIGATIONS OF UES AND UESI ON THE INTERIM CLOSING DATE

6.1 **Interim Closing Date Conditions**. UES and UESI shall not be obligated to consummate the transactions contemplated by this Agreement to be consummated on the Interim Closing Date unless on the Interim Closing Date each of the following conditions shall either have been satisfied or have been waived by UES and UESI in writing.

(a) **Release by CSLFC**. UES shall have received from CSLFC for the benefit of UES, UESI, and the Affiliates of each of them a general release in the form attached as Exhibit 9.2(b)(i).

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(b) No Assignment by CSLFC under the UES Servicing Agreement. UES shall have received a certificate from CSLFC to the effect that CSLFC has not assigned any of the rights of the "Corporation" under the UES Servicing Agreement as permitted by Section 8(d)(ii) thereof except in connection with the Indentures.

(c) Consent from Letter of Credit Banks. UES shall have received evidence that the Letter of Credit Banks have consented to the execution of this Agreement by Trustee by means of consents in the form attached as Exhibit 6.1(d).

ARTICLE 7
COVENANTS OF UES AND UESI

UES and/or UESI (as the case may be) covenant(s) as follows:

7.1 Investigation by BofA and Trustee. No investigation by BofA or Trustee or their respective representatives of the premises, properties, contracts, commitments, books, records, and affairs of UES made before or after the date of this Agreement shall affect any of the representations or warranties of UES or UESI contained in this Agreement. All such representations and warranties shall survive any such investigation.

7.2 Notice of Events. Throughout the period between the date of this Agreement and the Final Expiration Date, UES and UESI shall use their best efforts promptly to advise BofA and Trustee in writing of any and all material events and developments concerning UES's or UESI's financial position, assets, liabilities, results of operations, or business or any of the items or matters concerning UES or UESI covered by the representations and warranties contained in this Agreement.

7.3 No Other Negotiations. Prior to the Closing Date, neither UES, UESI, nor any representative of either of them shall conduct any negotiations or discussions with any party regarding a possible acquisition of any Servicing Function Assets or Other Assets of UES.

7.4 Compliance with ERISA. In any termination of its Employees, UES shall comply with all applicable requirements of ERISA and all other applicable laws.

7.5 Intercompany Transactions. UES will cause to be terminated, on or before the Effective Date and without obligation to UES, each and every agreement between UES and UESI or any of UESI's Affiliates relating to the Servicing Function.

7.6 Cooperation in Assessment of Assets. UES shall cooperate with BofA's evaluation of the Servicing Function Assets and Other Assets that BofA acquired on the Interim Closing Date or the Final Closing Date, to assist BofA's decision as to which of the Other Assets (if any) it will purchase and which of the Eligible Repurchase Assets (or all) it will cause UES to repurchase. In connection with such evaluation by BofA, UES shall permit BofA, Trustee, and their respective agents (including the New Servicer) at all times to have full and exclusive access to and control of the Servicing Function Assets and the Other Assets, including without limitation (a) the use with or without permanent modification of all computer software and programs and other items of Intangible Property included in the Servicing Function Assets or Other Assets, and (b) the management, direction, and control of all physical facilities and properties.

7.7 Cooperation in Transition to New Servicing Agreement. The parties acknowledge that Trustee intends to arrange for the Servicing Function to be performed by a New Servicer from and after the Interim Closing Date, in accordance with the terms of the New Servicing Agreement. UES shall cooperate in such transition and the transfer of the Servicing Function to the New Servicer as Trustee or the New Servicer may reasonably request. Without limiting the generality of the foregoing, UES agrees:

(a) until the date that is 30 days after the Final Closing Date, to encourage the Employees to perform the Servicing Function under the management, direction, and control of the New Servicer;

(b) until the date that is 120 days after the Final Closing Date, to consult with and advise the New Servicer with respect to the Servicing Function generally, including without limitation facilitating the New Servicer's familiarization with the Servicing Function and the applicability and prior application of the Servicing Function Assets and the Other Assets to the Servicing Function;

(c) to deliver the Records and all other account and other information and data to the New Servicer, to deliver ownership and control of all bank accounts (including lockbox arrangements, if any) relating to the Servicing Function, and to consult with and advise the New Servicer in order that the New Servicer may become familiar with such Records, information, bank accounts (including lockbox arrangements, if any), and data;

(d) until the date that is 120 days after the Final Closing Date, (i) to assist the New Servicer in its evaluation of the Employees and its decision as to which (if any) of the Employees to hire (including without limitation through the delivery to the New Servicer of historical employee records to the extent lawful to do so, and through consultations with and advice to the New Servicer in connection with its interpretation and evaluation of such historical employee records), (ii) to facilitate the hiring by the New Servicer of the Employees whom the New Servicer decides in its sole discretion to hire (including without limitation through a forbearance to terminate or transfer any such Employee until the earlier of the Designation Date (as defined in Section 8.5) of such Employee and the Final Expiration Date, it being agreed that after the earlier of such dates UES shall no longer be restricted by this Agreement in deciding whether to terminate such Employee; through a forebearance to discourage any such Employee from accepting employment with the New Servicer; and through the orderly and economical transfer of vested retirement benefits and other employee entitlements of any such Employee whom Trustee designates for hiring by the New Servicer), and (iii) to use its best efforts to ensure that no others of the Employees (for so long as they remain employees of UES) remain at the property covered by the Lease, or otherwise interfere with the performance of the Servicing Function by the New Servicer, after the Repurchase Date;

(e) to remove promptly from the property covered by the Lease all Purchased Assets repurchased pursuant to Section 2.5 and to do so without damaging such property or unreasonably disrupting the Servicing Function; and

(f) not to interfere, and not to cause or induce any other person or entity to interfere, in the performance by the New Servicer of the Servicing Function.

7.8 Post-Closing Payments to Trustee.

(a) Payment Obligation. UES agrees to pay or cause to be paid to Trustee, on or before the end of the Payment Period and in one or more payments as provided in Section 7.8(b), the aggregate sum of $2,000,000 (without interest or other regard to the time value of amounts paid) (such aggregate sum as it becomes due and payable in whole or in part, the "Post-Closing Payment").

(b) Source of Payments. To the extent it may lawfully do so, and before satisfying any contractual payment obligations to any other party for any other purpose, UES shall pay and deliver over to Trustee immediately upon receipt, and apply against the Post-Closing Payment, all proceeds of insurance that it receives under the E&O Policy. This obligation shall continue until the payment to Trustee in full of the Post-Closing Payment.

(c) Shortfall in Payments. If UES shall not have paid the Post-Closing Payment in full by the last day of the Payment Period, then on that day UES shall pay to Trustee the difference between (i) the Post-Closing Payment and (ii) the aggregate amount(s) (if any) theretofore paid in respect of the Post-Closing Payment.

(d) **Collateral for Post-Closing Payment**.

(i) **Collateral**. As collateral security for its obligation to make the Post-Closing Payment, UES shall purchase on or before the Interim Closing Date an obligation of the United States government, or other cash equivalent reasonably acceptable to Trustee, in the principal amount of $2,000,000 (the "Cash Collateral"). By assignment separate from the certificate(s) representing the Cash Collateral, or by another method reasonably satisfactory to Trustee, the right to receive all principal payments with respect to the Cash Collateral shall be assigned to Trustee. All interest payable with respect to the Cash Collateral shall be for the account of UES.

(ii) **Grant of Security Interest**. UES hereby assigns, conveys, mortgages, pledges, hypothecates, and transfers to Trustee, and grants to Trustee a security interest in, all of UES's right, title, and interest in, to, and under the Cash Collateral and proceeds of the Cash Collateral.

(iii) **Perfection and Maintenance of Security Interest**. UES shall deliver the Cash Collateral to Trustee on the Interim Closing Date, and thereafter until payment in full of the Post-Closing Payment permit Trustee to continue in uninterrupted possession thereof; and from time to time and at its own expense UES shall promptly execute and deliver all further instruments and documents, and take all further action, that may be necessary or desirable, or that Trustee may request, in order to perfect with first priority and otherwise maintain and protect the security interest granted hereby or to enable Trustee to exercise and enforce its rights and remedies with respect to the Cash Collateral. Without limiting the generality of the foregoing, UES shall execute and file such financing or continuation statements (or amendments thereto) and such other instruments or notices, and make such recordings, as may be necessary or desirable, or as Trustee may request, in order to perfect and preserve the security interest granted hereby, including without limitation the execution and filing of such instruments and recordings as may be or become necessary under applicable law relating to the creation and perfection of a security interest in the Cash Collateral. Without limiting Trustee's rights otherwise provided in this Section, UES agrees that upon any failure by UES to comply with its obligations contained in this Section (including without limitation the execution and filing of financing or continuation statements and other instruments or notices, and the making of recordings), Trustee has and shall have the power of attorney of UES with full authority to perform such obligations in UES's name, place, and stead. Such power is coupled with an interest and is irrevocable.

(iv) **Foreclosure of Security Interest**. Upon any failure of UES to pay the Post-Closing Payment in full

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at the end of the Payment Period, Trustee shall have all the rights of a secured creditor set forth in the UCC.

(v) Release of Collateral. From time to time upon partial payment of the Post-Closing Payment, Trustee shall release to UES a portion of the Cash Collateral with a principal amount approximately equal to (but in no case greater than) such payment; provided however that Trustee shall be under no obligation to release any such Cash Collateral if the principal amount of the Cash Collateral subject to a first priority perfected security interest in favor of Trustee after giving effect to such release would be less than the unpaid portion of the Post-Closing Payment. Upon the payment in full of the Post-Closing Payment, any remaining Cash Collateral in the possession of Trustee shall be released to UES.

(e) No Impairment of E&O Policy Rights. Nothing in this Section 7.8 shall be deemed to impose upon Trustee any obligations with respect to the assertion, filing, prosecuting, or settlement of claims under the E&O Policy.

(f) No Effect on Payment Obligation if E&O Policy Not Available. No obligation of UES and/or UESI contained in this Agreement shall be terminated, modified or otherwise affected by (i) whether the E&O Policy exists or continues in effect, (ii) whether any collections of proceeds of claims are received by UES or UESI under the E&O Policy if it exists, or (iii) whether the insurer under the E&O Policy (if it exists) asserts that defenses exist to its obligation to make claims payments. Nothing contained herein is intended in any way to reduce or eliminate the rights of UES or UESI to pursue any such claim that either of them may have against any of their insurers, including without limitation pursuant to the E&O Policy.

7.9 Maintenance of UES and UESI. Until the Repurchase Date, unless otherwise agreed in writing by BofA and Trustee:

(a) UES shall not issue any capital stock (or any right, warrants, options, or other securities convertible or exchangeable into capital stock) to any person other than UESI, or enter into any commitment or other agreement to do so;

(b) Neither UES nor UESI shall, and UESI shall not permit UES to, seek Bankruptcy with respect to UES; and UES and UESI at their expense shall use all reasonable efforts to oppose any efforts of any other person to seek Bankruptcy with respect to UES; and

(c) UESI shall not Transfer all or substantially all of the capital stock of UES, nor permit UES to do any act prohibited by Section 7.9(a) or (b).

7.10 **Press Releases and Public Statements**. Neither UES nor UESI, nor any of their respective Affiliates, shall make any public statements (including without limitation any statement to Employees), or issue any press releases or other information, relating to the subject matter of this Settlement Agreement without first consulting with BofA and Trustee and agreeing with BofA and Trustee on the text of such statements, press releases, or other information; provided however that the parties may answer questions or respond to inquiries in a manner consistent with any prior public statement or information that complied with this Section and/or Section 8.1 (and UES and UESI shall promptly deliver to BofA and Trustee copies of any written answers to questions, or written responses to inquiries, that are given); and provided further that no such prior consultation or agreement shall be required in connection with public statements or information required to be made or furnished under applicable law.

7.11 **Cooperation in Obtaining Accountants' Work Papers**. UES and UESI shall request and authorize Peat Marwick Main & Co. to deliver to Trustee copies of all work papers prepared and used by Peat Marwick Main & Co. in connection with consulting performed by Peat Marwick Main & Co. related to the Servicing Function.

7.12 **Cooperation in Reconciling Accounts; Payment**. UES and UESI shall cooperate with Trustee in causing to be conducted as soon as practicable the complete reconciliation of the cash flow to the custodial cash accounts (including without limitation the universal account and the suspense account) and the trustee cash accounts related to the Student Loans and the Indentures, and the loan service activity reports and trustee cash account statements related thereto. Such reconciliation shall be reviewed and certified by a nationally-recognized firm of independent public accountants hired by UES and reasonably acceptable to Trustee. The expense of conducting such reconciliation shall be for the account of UES. Any amount determined to be due from UES shall be paid to Trustee promptly upon determination.

7.13 **Cooperation with respect to Litigation and Similar Matters**. With respect to causes of action Transferred to BofA under the terms of this Agreement, litigation matters affected by this Agreement, and any other investigative, administrative, regulatory, legislative, arbitrative, or other similar matters within or outside the context of litigation as reasonably requested by BofA or by Trustee, UES and UESI shall

(a) Permit any witnesses who may be employed by either of them to take time, during normal business hours and at such other times as may be mutually convenient, to consult with attorneys for BofA or for Trustee (as the case may be), to work with attorneys for BofA or for Trustee (as the case may be) in responding to discovery requests (and similar requests outside the context of litigation), to attend pretrial proceedings (and similar proceedings outside the context of litigation), to arrange and attend witness interviews, to participate in pretrial preparation (and similar preparation outside the context of litigation), to attend and participate in trial (and similar proceedings outside the context of litigation), and to take any other actions that attorneys for BofA or for Trustee (as the case may be) may reasonably request in connection with such matters; provided however that neither UES nor UESI shall be entitled to expenses or compensation in connection with time so spent by their employees; and

(b) Make available, at no cost to BofA or to Trustee (as the case may be), during normal business hours and at such other times as may be mutually convenient, all documents (including without limitation the Intangible Property, and any Records prepared prior to the Interim Closing Date) to which attorneys for BofA or for Trustee (as the case may be) may require access for purposes of inspection and/or copying in connection with such matters; provided however that attorneys for BofA or for Trustee (as the case may be) shall have the right to inspect such documents where they are stored and to remove such documents if necessary for copying, further inspection, or introduction into evidence, and provided further that any such copying shall be at the expense of BofA or Trustee (as the case may be).

7.14 **Sales Taxes**. UES shall pay any sales or other taxes resulting from the Transfer to UES of any of the Purchased Assets that UES is required to repurchase.

7.15 **September Financial Statements**. UESI shall provide to BofA and Trustee as soon as they are available the unaudited consolidated and consolidating financial statements of UESI as at September 30, 1988 and for the eight months then ended, consisting of balance sheets, statements of income/loss, and statements of changes in financial position, all certified as accurate and complete by the President and Chief Financial Officer of UESI.

7.16 **Maintenance of Insurance; Delivery of Proceeds**. (a) From the date of this Agreement until (and including) the Final Expiration Date, UES shall maintain in full force and effect liability and property damage insurance covering UES's activities with respect to the Servicing Function and covering UES's insurable interest in the Purchased Assets respectively, (i) under policies as in effect on October 3, 1988, or (ii) if any policy(ies) as in effect on October 3, 1988 are cancelled, then under policies issued by insurers with a Best's rating of A or higher and with coverages no lower than coverages as in effect on October 3, 1988. With respect to casualty losses occurring to the Purchased Assets during such period, UES shall use its best efforts promptly to collect proceeds payable under such property damage policies and promptly to remit such proceeds to Trustee.

(b) Notwithstanding the provisions of Section 7.16(a), UES shall have no obligation to maintain in full force and effect the E&O Policy, nor to replace the E&O Policy if it is cancelled or is otherwise not in full force and effect.

(c) UES hereby waives in behalf of its insurers any subrogation claims that may be asserted against BofA or Trustee by any such insurer.

7.17 Best Efforts to Close. UES and UESI shall use their best efforts to fulfill or cause to be fulfilled all of the conditions set forth in Article 5 of this Agreement over which they have control or influence.

ARTICLE 8
COVENANTS OF BofA AND TRUSTEE

8.1 Press Releases and Public Statements. Neither BofA nor Trustee nor any of their respective Affiliates, shall make any public statements (including without limitation any statement to Employees), or issue any press releases or other public information relating to the subject matter of this Settlement Agreement, without first consulting with UES and UESI and agreeing with UES and UESI on the text of such statements, press releases, or other information; provided however that the parties may answer questions or respond to inquiries in a manner consistent with any prior public statement or information that complied with this Section and/or Section 7.10 (and BofA and Trustee shall promptly deliver to UES copies of any written answers to questions, or written responses to inquiries, that are given); and provided further that no such prior consultation or agreement shall be required in connection with public statements or information required to be made or furnished under applicable law.

8.2 Cooperation in Reconciling Accounts; Payment. Trustee shall cooperate with UES and UESI in causing to be performed as soon as practicable the complete reconciliation of the cash flow to the custodial cash accounts (including without limitation the universal account and the suspense account) and the trustee cash account related to the Student Loans and the Indentures, and the loan service activity reports and trustee cash account statements related thereto. Any amount determined to be due to UES shall be paid by Trustee to UES promptly upon determination.

8.3 Non-Interference in Obtaining Releases. Trustee shall not interfere with efforts of UES and UESI to obtain for the benefit of UES releases from the United States Department of Education, from the Higher Education Assistance Foundation, and from Guarantors and Insurers (each as defined in the UES Servicing

Agreement) of claims related to the Student Loans and UES's conduct in connection with the Servicing Function; provided however that Trustee shall have no obligation under this Section 8.3 if complying with this Section 8.3 would result in the Trustee's incurring any expense or other obligation or liability, or would prejudice Trustee's own negotiations with any such entity as Trustee determines in its discretion.

8.4 **Sales Taxes**. BofA shall pay any sales or other taxes resulting from the Transfer to BofA of the Purchased Assets.

8.5 **Designation of Employees**. From time to time between the Interim Closing Date and the Final Expiration Date, Trustee shall designate to UES by written notice the names of such of the Employees (if any) whom the New Servicer desires to hire and such of them (or all) whom the New Servicer does not desire to hire. With respect to any Employee so designated, the obligation of BofA to reimburse UES for direct Employee costs related to that Employee pursuant to Section 2.4(b)(iii) shall cease as of the date that is two business days after the date (the "**Designation Date**") of receipt by UES of such written notice.

8.6 **Cooperation with respect to Litigation and Similar Matters**. With respect to litigation matters affected by this Agreement and any other investigative, administrative, regulatory, legislative, arbitrative, or other similar matters within or outside the context of litigation as reasonably requested by UES, BofA and Trustee shall

(a) Permit any witnesses who may be employed by BofA or Trustee (as the case may be) to take time, during normal business hours and at such other times as may be mutually convenient, to consult with attorneys for UES and UESI, to work with attorneys for UES and UESI in responding to discovery requests (and similar requests outside the context of litigation), to attend pretrial proceedings (and similar proceedings outside the context of litigation), to arrange and attend witness interviews, to participate in pretrial preparation (and similar preparation outside the context of litigation), to attend and participate in trial (and similar proceedings outside the context of litigation), and to take any other actions that attorneys for UES and UESI may reasonably request in connection with such matters; provided however that neither BofA nor Trustee shall be entitled to expenses or compensation in connection with time so spent by its employees; and

(b) Make available, at no cost to UES and UESI, during normal business hours and at such other times as may be mutually convenient, all documents (including without limitation the Intangible Property, and any Records prepared prior to the Interim Closing Date) to which attorneys for UES and UESI may require access for purposes of inspection and/or

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copying in connection with such matters; provided however that attorneys for UES and UESI shall have the right to inspect such documents where they are stored and to remove such documents if necessary for copying, further inspection, or introduction into evidence, and provided further that any such copying shall be at the expense of UES and UESI.

8.7 Retention of Certain Assets. Notwithstanding Section 2.5 and Schedule 2.5, BofA shall retain and not Transfer back to UES on the Final Closing Date or the Repurchase Date (as the case may be) (a) any item of Equipment (other than items of Equipment described in item 5 or item 6 of Schedule 2.5) that was on the date Transferred to BofA in good operating condition and repair except to the extent not material, and (b) all forms and supplies other than those that in BofA's reasonable discretion are not useable in the Servicing Function by BofA or the New Servicer.

8.8 Best Efforts to Close. Trustee shall use its best efforts to fulfill all of the conditions set forth in Article 6 of this Agreement over which it has control or influence.

ARTICLE 9
TERMINATION OF UES SERVICING CONTRACT; RELEASES

9.1 Termination, and Possible Reinstatement, of UES Servicing Contract. Subject to reinstatement as provided in the following sentence, the UES Servicing Agreement is hereby terminated. If the Final Expiration Date occurs other than by reason of the occurrence of the Final Closing Date, then the UES Servicing Agreement shall thereupon be immediately and automatically reinstated without notice or declaration of any kind.

9.2 Releases Subject to Condition Subsequent.

(a) Release by BofA, Trustee, and Letter of Credit Banks. As of the Interim Closing Date, and subject to Section 12.10(b), BofA and Trustee (in its own behalf and in behalf of the Letter of Credit Banks) severally release UES, UESI, and the Affiliates of each of them from any and all liability and claims (whether sounding in tort or in contract) arising out of, resulting from, or connected with UES's conduct in servicing Student Loans, whether known or unknown and whether existing or hereafter arising, other than any liabilities and claims arising out of the breach of this Agreement by UES or UESI. The release contained in this Section constitutes and is intended to constitute an explicit waiver of each and all of the provisions of California Civil Code Section 1542, which reads as follows:

> "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

The release contained in this Section is expressly intended by the parties to be for the benefit of the Affiliates of UES and UESI and may be enforced by the Affiliates of UES and UESI as third party beneficiaries.

(b) Release by CSLFC. Trustee shall undertake to obtain on or before the Interim Closing Date for the benefit of UES, UESI, and the Affiliates of each of them a general release by CSLFC, in the form attached as Exhibit 9.2(b).

(c) Release by UES and UESI. As of the Interim Closing Date, UES and UESI severally release generally BofA, Trustee, the Letter of Credit Banks, CSLFC, the New Servicer, and all Affiliates of any of them from any and all liability and claims (whether sounding in tort or in contract) arising out of, resulting from, or connected with (i) any claim for compensation or payment of any kind related to UES's conduct in servicing Student Loans (including without limitation under the UES Servicing Agreement), whether or not any such payment has been Accrued or otherwise recognized by UES and whether or not billed, (ii) the UES Servicing Agreement, the Servicing Function, and any claims of third parties against UES or UESI relating thereto, and (iii) any liability and claims relating to alleged interference with business operations or opportunity, lost profits, defamation, or any other allegation arising out of the settlement effected by this Agreement, and including without limitation in any such case described in the foregoing clauses (i), (ii), and (iii) any acts or omissions of BofA, Trustee, the Letter of Credit Banks, CSLFC, the New Servicer, or any Affiliate of any of them relating thereto. The release contained in this Section constitutes and is intended to constitute an explicit waiver of each and all of the provisions of California Civil Code Section 1542, which reads as follows:

> "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

The release contained in this Section is expressly intended by the parties to be for the benefit of the Letter of Credit Banks, CSLFC, the New Servicer, their Affiliates, and the Affiliates of BofA and Trustee, and may be enforced by the Letter of Credit Banks, CSLFC, the New Servicer, their Affiliates, and the Affiliates of BofA and Trustee as third party beneficiaries.

ARTICLE 10
INDEMNIFICATION

10.1 Indemnification of UES, UESI, and Affiliates. Subject to Section 12.10(b), from and after the Interim Closing Date, BofA shall indemnify, defend, and hold UES, UESI, and the Affiliates of each of them harmless from and against any and all losses, costs, claims, damages, assessments, liabilities, judgments, expenses, commitments, obligations, or causes of action (including without limitation reasonable attorneys' fees) (collectively "Losses") arising out of any of the following:

(a) claims made by holders of notes, bonds, and other evidences of indebtedness of CSLFC issued pursuant to the Indentures and secured by the Student Loans, to the extent such claims arise out of the conduct of UES in servicing such Student Loans (but excluding claims made by the Letter of Credit Banks or any of them (i) in their capacity as issuers of letters of credit to support such notes, bonds, and other evidences of indebtedness of CSLFC, (ii) in their capacity as holders of the Bank Notes or the Additional Bank Notes (each as defined in the Indentures), or (iii) in any other capacity, including without limitation in their individual capacity, in their fiduciary capacity, or otherwise);

(b) any breach of warranty, misrepresentation, or nonfulfillment in whole or in part of any obligation on the part of BofA or Trustee under this Agreement, any schedule or exhibit, or any agreement, instrument, certificate, or document executed by BofA or Trustee pursuant to or in connection with this Agreement or the transactions contemplated hereby;

(c) claims made against UES by Peat Marwick Main & Co. that relate to the Servicing Function and arise out of claims made against Peat Marwick Main & Co. by BofA, Trustee, CSLFC, or any Letter of Credit Bank that relate to the Servicing Function, but specifically excluding any such claim against UES that is based on allegations of fraud, misrepresentation or omission of material facts, or of failure of any kind to cooperate with or provide requested information to Peat Marwick Main & Co. in its performance of auditing, consulting, or other services for or on behalf of UES, unless UES prevails in a final judgment on the merits of such claim against it by Peat Marwick Main & Co.; or

(d) the conduct by BofA or the New Servicer (as the case may be) of the Servicing Function from and after the Interim Closing Date.

The indemnity contained in this Section is expressly intended by the parties to be for the benefit of the Affiliates of UES and UESI and may be enforced by the Affiliates of UES and UESI as third party beneficiaries.

10.2 Indemnification of BofA, Trustee, CSLFC, and Affiliates. From and after the Interim Closing Date, UES shall indemnify, defend, and hold BofA, Trustee, CSLFC, the New Servicer, and the Affiliates of each of them harmless from and against any and all Losses arising out of any of the following:

(a) any breach of warranty, misrepresentation, or nonfulfillment in whole or in part of any obligation on the part of UES or UESI under this Agreement, any schedule or exhibit, or any agreement, instrument, certificate, or document executed by UES or UESI pursuant to or in connection with this Agreement or the transactions contemplated hereby;

(b) any failure of UES or UESI to comply with the applicable bulk sales law of the State of California;

(c) any failure of UES to Transfer to BofA good title to the Purchased Assets free and clear of all claims, liens, title defects and objections, easements, equities, rights of way, covenants, restrictions, security interests, or other encumbrances, including without limitation leases, chattel mortgages, conditional sales contracts, collateral security arrangements, and other title- or interest-retaining agreements;

(d) any Transfer of Assets to BofA that was illegal, unlawful, or otherwise in violation of the rights of others;

(e) any inability of BofA to consummate a Transfer back to UES of any Purchased Asset(s) as BofA desires in accordance with the provisions of Section 2.5;

(f) any failure to comply with the requirements of Section 3440 of the California Civil Code; or

(g) except as specifically described in Section 2.6, any claims against or liabilities of UES or UESI arising prior to, or existing on, the Interim Closing Date, including without limitation claims made by Employees or consultants.

The indemnity contained in this Section is expressly intended by the parties to be for the benefit of CSLFC, the New Servicer, and their, BofA's, and Trustee's Affiliates and may be enforced by CSLFC, the New Servicer, and their, BofA's, and Trustee's Affiliates as third party beneficiaries.

10.3 Defense and Settlement of Claims.

(a) UES or BofA (as the case may be) (the "**Notifying Party**") shall give written notice to the other party (the "**Indemnifying Party**") promptly upon becoming aware of the filing of a claim covered by the indemnification provisions contained in Section 10.1 or Section 10.2 against any person indemnified as there provided (the "**Indemnified Party**"). Such notice shall set forth the Notifying Party's tender of the control of the defense of such claim to the Indemnifying Party. The Indemnifying Party shall provide the Notifying Party with written notice of its decision whether or not to accept the Notifying Party's tender of the control of the defense of the claim within 15 business days after the receipt by the Indemnifying Party of such tender. If the Indemnifying Party refuses to accept the Notifying Party's tender of the control of the defense of the claim within that time, then the dispute as to whether the Indemnifying Party shall accept the tender of the control of the defense of the claim shall be submitted to a reference proceeding pursuant to California Code of Civil Procedure § 638 convened and conducted in accordance with Section 10.3(e). If the Indemnifying Party assumes the control of the defense of the claim voluntarily or after reference, then the Notifying Party shall be entitled to participate in the defense of such claim, provided however that any such participation shall be at the Notifying Party's sole expense. The Notifying Party shall also be entitled to consent to the counsel selected by the Indemnifying Party, which consent shall not be unreasonably withheld. The Notifying Party shall cooperate with reasonable requests by the Indemnifying Party made in connection with the Indemnifying Party's control of the defense of any claim assumed by the Indemnifying Party. The Notifying Party shall be entitled to reimbursement for reasonable costs and expenses incurred by the Notifying Party in connection with any such request by the Indemnifying Party, but shall not be entitled to expenses or compensation in connection with time spent by its employees. The Indemnifying Party shall make such reimbursement not later than 30 days after the Notifying Party shall have submitted to the Indemnifying Party a written claim for such reimbursement. If the Indemnifying Party disputes all or any portion of such claim of the Notifying Party, then the Notifying Party and the Indemnifying Party shall submit such dispute to a reference proceeding convened and conducted in accordance with Section 10.3(e).

(b) The Indemnifying Party shall not be entitled to reimbursement for costs and expenses incurred in connection with the defense of any claim.

(c) Any judgment pursuant to a final order entered with respect to any claim shall be payable by the Indemnifying Party.

(d) The Indemnifying Party shall not settle a Claim, or pay any judgment with respect to any claim other than any judgment pursuant to a final order, without the prior written approval of the Notifying Party, which approval shall not be unreasonably withheld. Any amount required to be paid pursuant to any such approved settlement or judgment shall be payable by the Indemnifying Party.

(e) If the Notifying Party and the Indemnifying Party cannot resolve their differences relating to the assumption of the defense of a claim or the reimbursement of expenses to the Notifying Party in the manner specified in Section 10.2(a), then each of them shall submit to a court-ordered reference within 10 business days following the end of the respective periods specified in Section 10.2(a) for resolving such differences. If it is determined that the defense of a claim was properly tendered by the Notifying Party to the Indemnifying Party, then the Indemnifying Party shall assume the defense of the claim. If it is determined that the defense of a claim was not properly tendered by the Notifying Party to the Indemnifying Party, then the Indemnifying Party shall not assume the defense of the claim. If it is determined that reimbursement, or any part of it, was properly claimed, then such reimbursement, or such part, shall be paid. If it is determined that reimbursement, or any part of it, was not properly claimed, then such reimbursement, or such part, shall not be paid. The Notifying Party and the Indemnifying Party shall each pay 50% of the fees and expenses of the reference; and all other costs and expenses associated with the reference proceeding shall be borne by the party incurring them.

ARTICLE 11
GUARANTY BY UESI

11.1 Guaranty. UESI hereby unconditionally guarantees to BofA and Trustee and the successors and assigns of each of them the timely and faithful performance by UES of all of the obligations of UES under this Agreement, including without limitation the obligations with regard to (a) the payment by UES of the Post-Closing Payment and the arrangement and maintenance by UES of the collateral therefor, (b) all covenants of UES with respect to cooperation in the transition to the New Servicing Agreement, and (c) all of UES's indemnification obligations under Section 10.2. Such guaranty by UESI is referred to in this Agreement as the "Guaranty".

11.2 Changes; Waivers. The Guaranty shall not be affected by any deviation by conduct from, or alteration or modification by agreement of, the provisions of this Agreement by BofA, Trustee, and/or UES without the knowledge or consent of UESI. UESI shall not be exonerated, and this Guaranty shall not be released, extinguished, modified, or in any way affected, by a failure on the part of BofA or Trustee to enforce any or all of its rights or remedies under this Agreement, whether pursuant to the terms of this Agreement or otherwise at law or in equity. UESI hereby waives any statute of limitations affecting its liability hereunder or the enforcement thereof and any applicable rights of UESI under the California Civil Code, and UESI understands and agrees that the exercise of certain rights and remedies by BofA and/or Trustee may affect or eliminate UESI's right of subrogation against UES.

11.3 Continuing Effect. The Guaranty is a continuing one, and unless earlier terminated or released by both BofA and Trustee it shall terminate only upon the payment by UES of the Post-Closing Payment and the performance by UES of all of its other duties and obligations contained in this Agreement.

11.4 **Waiver of Notices**. UESI waives notice of (a) any default by UES in the payment by UES of the Post-Closing Payment or the performance by UES of any others of its obligations under this Agreement, (b) acceptance by UES of the Guaranty, and (c) any assignment of all or any part of the interest of UES under this Agreement.

11.5 **Future Modifications**. UESI hereby acknowledges, consents, and agrees that from time to time BofA and/or Trustee (as the case may be, depending on whether the performance is owed to one or the other or both of them) may (a) extend the time for performance or otherwise modify, alter, or change the obligations of UES or any part thereof, (b) extend the time for payment of the Post-Closing Payment or any other amounts hereby guaranteed, and (c) receive and accept notes, checks, and other instruments from UES for the payment of money and extensions and renewals thereof without in any way releasing or discharging UESI from its obligations under the Guaranty. UESI expressly waives notice of presentment of any such note or notes, notice of default in the payment thereof at maturity, and protest thereof.

11.6 **No Prior Exhaustion**. UESI consents that it shall not be necessary for BofA or Trustee, in order to enforce the Guaranty, first to institute suit or exhaust their respective legal remedies against UES or to join UESI and UES in any common proceeding or to resort first to any collateral that they or either of them may hold as security for the performance of UES's obligations under this Agreement.

11.7 **Immediate Enforcement**. BofA and Trustee shall be entitled immediately to enforce the Guaranty against UESI upon any default by UES under this Agreement. The Bankruptcy of UES shall be deemed a default of UES under this Agreement and shall not relieve UESI of its obligations under the Guaranty.

ARTICLE 12
MISCELLANEOUS

12.1 **Expenses**. BofA, Trustee, UES, and UESI shall each pay their respective costs and expenses (including all legal and accounting expenses) relating to this Agreement, the negotiations leading up to this Agreement, and the performance of this Agreement.

12.2 **Amendment**. This Agreement shall not be amended except by a writing duly executed by BofA, Trustee, UES, and (subject to Sections 11.2 and 11.5) UESI.

12.3 **Entire Agreement**. This Agreement contains all of the terms and conditions agreed upon by the parties relating to the subject matter of this Agreement and supersedes all prior and contemporaneous agreements, negotiations, correspondence, undertakings, and communications of the parties, oral or written, respecting that subject matter.

12.4 **Bulk Sales**. BofA and UES hereby waive compliance with the provisions of the California bulk sales law contained in Article 6 of the UCC, if applicable, in connection with the transactions contemplated by this Agreement.

12.5 **Knowledge Qualification**. **"Best knowledge"** of a natural person means actual knowledge of such natural person, and **"best knowledge"** of a corporate person means actual knowledge of the directors, officers, and employees of such corporate person, in each case after reasonable inquiry and investigation.

12.6 **Governing Law; Consent to Jurisdiction**. This Agreement shall be governed by, and construed in accordance with, the laws of the State of California applicable to contracts entered into and fully to be performed within the State of California by California residents. The parties hereby irrevocably agree that any legal action, suit, or proceeding with respect to any of their obligations or liabilities or any other matter under or arising out of or in connection with this Agreement and for recognition or enforcement of any judgment rendered in any such action, suit, or proceeding may be brought in the United States District Court for the Northern District of California or the Central District of California, or in the Superior Court of the State of California for the City and County of San Francisco or the City and County of Los Angeles, and by execution and delivery of this Agreement, each party hereby irrevocably accepts and submits to the non-exclusive jurisdiction of each of the aforesaid courts in personam generally and unconditionally with respect to any such action, suit, or proceeding for itself and in respect of any of its property. The parties further agree that final judgment in any action, suit, or proceeding referred to herein shall be conclusive and may be enforced in any other jurisdiction within or outside the United States of America by suit on the judgment, a certified or exemplified copy of which shall be conclusive evidence of the fact and of the amount of such obligations and liabilities. Each party irrevocably consents and agrees to the service of any and all legal process, summonses, notices, and documents out of any of the aforesaid courts in any such action, suit, or proceeding by mailing copies thereof by certified mail, postage prepaid, to such party at its address set forth in Section 12.8 or to its then designee, appointee, and agent for service. Each party agrees that service upon it or any such designee, appointee, and agent as provided for herein shall constitute valid and effective personal service upon it and that the failure of any such designee, appointee, and agent to give any notice of such service to it shall not impair or affect in any way the validity of such service or any judgment rendered in any action or proceeding based thereon. In addition, the parties hereby irrevocably and unconditionally waive any objection that they may now or hereafter have to the laying of

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venue of any of the aforesaid actions, suits, or proceedings arising out of or in connection with this Agreement brought in any of the aforesaid courts, and hereby further irrevocably and unconditionally waive and agree not to plead or claim that any such action, suit, proceeding brought in any such court has been brought in an inconvenient forum.

12.7 Construction. No provision of this Agreement shall be construed against any party on the ground that such party or its counsel drafted the provision.

12.8 Notices. All notices, requests, demands, and other communications made in connection with this Agreement shall be in writing and shall be deemed to have been duly given on the date of delivery, if delivered to the persons identified below, or three days after mailing if mailed by certified mail, postage prepaid and return receipt requested, addressed as follows:

If to BofA or Trustee:
Bank of America National Trust &
Savings Association
555 California Street
San Francisco, California 94104
Attention: Mr. John R. Lloyd, Jr.
Senior Vice President
Capital Markets Oper. #3291
42nd Floor

With copies to:
Bank of America National Trust &
Savings Association
555 California Street
San Francisco, California 94104
Attention: H. Helmut Loring, Esq.
Senior Vice President and
Assistant General Counsel
Legal Department # 3017
8th Floor

and to:
Heller, Ehrman, White & McAuliffe
333 Bush Street, Suite 3216
San Francisco, California 94104
Attention: David A. Rosinus, Esq.

If to UES or UESI:
Baker & McKenzie
725 South Figueroa Street, 36th Floor
Los Angeles, California 90017
Attention: James J. Slaby, Jr., Esq.

Such persons and addresses may be changed from time to time by means of a notice given in the manner provided in this Section.

12.9 Severability. If any provision of this Agreement is held to be unenforceable for any reason, it shall be adjusted rather than voided, if possible, in order to achieve the intent of the parties to this Agreement to the full extent possible. In any event, all other provisions of this Agreement shall be deemed valid and enforceable to the full extent possible.

12.10 __Survival__.

(a) All representations and warranties contained in this Agreement shall survive the Final Closing Date until the date that is two years after the Final Closing Date.

(b) The releases delivered by BofA, Trustee (in its capacity as trustee under the Indentures and in behalf of the Letter of Credit Banks), and CSLFC pursuant to or as contemplated by Section 9.2(a) and Section 9.2(b), and the indemnification by BofA pursuant to Section 10.1(a), (b), and (c) (but not Section 10.1(d)), shall be void ab initio and be of no force or effect

> (i) on 30 days' prior written notice upon the breach by UES or UESI of any of their respective obligations under this Agreement (unless such breach can be cured and within such 30-day period UES or UESI (as the case may be) cures such breach);
>
> (ii) without notice or declaration of any kind if any representation or warranty of UES or UESI contained in Sections 3.7, 3.15, 3.25, 3.27, 3.29, 3.31, or 3.32 proves to have been untrue as of any date made or deemed to have been made; or
>
> (iii) without notice or declaration of any kind upon the occurrence of the Bankruptcy of UES or UESI prior to the expiration of 91 days after the Final Closing Date, unless any involuntary proceeding or case giving rise to such Bankruptcy is dismissed by final order of a court of competent jurisdiction within 60 days after the commencement of such proceeding or case.

Nothing contained in this Section 12.10(b) shall be deemed otherwise to limit the rights and remedies available at law or in equity as a result of any breach of this Agreement, the falsity of any representation or warranty contained in this Agreement, or otherwise.

(c) In the event of the voidance of the releases of BofA, Trustee (in its capacity as trustee under the Indentures and in behalf of the Letter of Credit Banks), and CSLFC contained or described in this Agreement, the termination of the indemnity by BofA contained in this Agreement, or any other termination of this Agreement, the parties hereto acknowledge and agree that this Agreement and all negotiations and proceedings connected herewith shall be without prejudice to any of the rights or remedies of the parties hereto, and no part of this Agreement, or any statement by any party, any findings of fact, or any conclusions of law related thereto may be used in any manner by any party hereto in any action, suit, or proceeding as evidence of the respective rights, duties, or obligations of the parties. The parties further acknowledge and agree that all undertakings and agreements contained in this Agreement have been agreed to solely for the purpose of effectuating a voluntary settlement among them and shall not be deemed to constitute an admission or concession by any of them for any purpose, nor shall such undertakings and agreements or this Agreement itself be deemed to constitute a waiver of any legal position which any of the parties hereto might otherwise assert in any context.

12.11 Waiver. No waiver of any term or condition contained in this Agreement shall be effective unless it is signed by the party claimed to be bound by the waiver. The waiver of any term or condition of this Agreement by any party shall not be construed as a waiver of any subsequent breach or failure of the same term or condition, or a waiver of any other term or condition of this Agreement.

12.12 Assignment. Except as otherwise provided herein, no party to this Agreement may assign or delegate, by operation of law or otherwise, all or any portion of its rights, obligations, or liabilities under this Agreement without the prior written consent of the other parties to this Agreement, which may be withheld in such parties' absolute discretion; provided however that either or both of BofA and/or Trustee may assign any or all of their respective rights and delegate any or all of their respective obligations hereunder, in their absolute discretion without the prior consent of UES or UESI, but notwithstanding any such delegation of obligations BofA and Trustee shall remain primarily liable for the performance or other satisfaction of their respective delegated obligations.

12.13 Costs of Enforcement. If any party to this Agreement seeks to enforce its rights under this Agreement by legal proceedings, the non-prevailing party shall pay all costs and expenses incurred by the prevailing party, including without limitation all reasonable attorneys' fees.

12.14 Third-Party Beneficiaries. Except as provided in Sections 9.2, 10.1, and 10.2, nothing in this Agreement shall confer any rights upon any person or entity which is not a party to this Agreement.

12.15 Acts of Trustee. The obligations of Trustee under this Agreement are undertaken solely in its capacity as trustee under the Indentures, and the responsibility of Trustee under this Agreement shall be limited to its role as trustee.

12.16 Counterparts. This Agreement may be signed in any number of counterparts with the same effect as if the signatures to

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each counterpart were upon a single instrument. All counterparts shall be deemed an original of this Agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date set forth in the first paragraph of this Agreement.

BofA:

BANK OF AMERICA NATIONAL TRUST & SAVINGS ASSOCIATION, in its individual capacity

By: ______________________________
Title: ____________________________

By: ______________________________
Title: ____________________________

Trustee:

BANK OF AMERICA NATIONAL TRUST & SAVINGS ASSOCIATION, not in its individual capacity but solely as trustee under the Indentures

By: ______________________________
Title: ____________________________

By: ______________________________
Title: ____________________________

UES:

UNITED EDUCATION & SOFTWARE

By: ______________________________
Title: ____________________________

UESI:

UNITED EDUCATION & SOFTWARE, INC.

By: ______________________________
Title: ____________________________

UES STAFF

Name	Last Known Position
*Allen, Steve	Operations Control, Division Manager
Angulo, Terry	Manager, Customer Service
Barragan, Gary	Customer Service Dept.
Baumgartner, Joe	Controller (Service)
Benedict, Lee	General Manager
Bevers, Bob	Special Projects with UES, Inc.
Bittner, Jim	UES, Inc., Assistant Controller
*Bookout, Lori	Sr. Technical Support Analyst
Bradshaw, Cindy	Supervisor of Customer Service
*Bryant, Ethyl	Collections Manager
*Cipolla, Steve	Skip Tracing
*Constantine, James	Data Processing
Cotton, Juliette	Programmer
Curtin, Kim	Claims Supervisor
Dexter, Charles	Director of MIS
*Eddington, Arlene	Supervisor of Loan Records Control
*Elder, Gary	Operations Management
*Ellison, Jim	Financial Analyst
*Garcia (Elliot), Leita	Special Projects
Greenman, Ann	Computer Operator
Guthrie, Doug	Supervisor of Fiancial Reporting
Hall, Brian	Director of MIS Corporate Headquarters
Hawkins, Howard	Operations Management
Hertzog, Bill	Contract Consultant
Hurtt, Charlie	Processing Department Manager
Johnson, Ben	Consultant
Kitts, Judy	Supervisory Responsibility for Filing Department
Kruthers, Jim	Operations, Management-Accounting
Loritsch, Rich	Consultant
Mallory, Tim	System Consultant
Miller, Rex	DP Programmer
Plude, Jane	Unknown
*Rousch, Jeanne	Claims Department-Defaults Supervisor
*Sedoris, Riqui	Special Projects
Southall, Leann	Unknown
Speights, Marilyn	Training Manager
Staff, Gretchen	General Manager
Starr, Bill	MIS Director - UES, Inc.
Tatro, Gene	Compliance Management
Tengbergen, Robert	Manager of Accounting and Finance
Tucker, Anita	Claims
*Van Willigan, Larry	Customer Service Division Manager
Walker, Rosairo	Unknown

* Currently employed by CMSC

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Senate Permanent Subcommittee on Investigations

EXHIBIT # 34-D

MEMORANDUM

TO: Department of Education ("ED")

FROM: Bank of America, as Trustee for the CSLFC Indentures ("the Trustee")

DATE: January 5, 1989

RE: UES Database Tapes

INTRODUCTION

The office of the Inspector General of the Department of Education ("the IG") has asked the Trustee certain questions regarding the availability of evidence documenting the potential existence of UES computer programs designed to enter false due diligence records on loans serviced by UES, including questions regarding the availability of existing UES month-end data base tapes. As previously reported to ED, the Trustee has performed a number of analyses and reviews of the available UES data base tapes and has, on various occasions, reported its findings to ED. This memorandum is to confirm to ED and the IG that the Trustee has previously provided to the IG copies of all available and readable month-end UES database tapes and that the Trustee's analysis has found no evidence of any computer programs designed to enter false due diligence records on UES serviced loans other than the FIX and COMFIX programs previously identified.

1. The Trustee Is Aware Of No "Falsification" Programs Other Than FIX And COMFIX.

Michael Difede was engaged in August 1988 by the Trustee to perform various analyses related to the UES servicing failure. Mr. Difede has served as a consultant to both management and counsel for the Trustee in defending the Trustee with regard to claims asserted and lawsuits commenced by those banks who issued letters of credit in connection with the bond and note financings of California Student Loan Finance Corporation. Mr. Difede is president of American Fiduciary Services, which specializes in banking applications, operations and procedures, especially systems operations for "back office" operations such as trust accounting, corporate clearance, system procedures and data processing. Mr. Difede has extensive experience in the management of systems failures and recoveries. In performing his work for the Trustee, Mr. Difede analyzed UES computer tapes on which borrower history database and program libraries were stored.

In Mr. Difede's analysis of the FIX and COMFIX computer programs, discussed at length in his March 29, 1989 report to ED, he analyzed all available and readable UES month-end backup tapes in the relevant time frame, which incorporated UES borrower due diligence histories and, usually, programs used and/or developed in each month or previous months. That work was undertaken in response to the discovery that large numbers of computer entries on the October 1987 month-end tape, allegedly documenting due diligence letters transmitted and phone calls made for the months of March 1987 through September 1987, did not appear on the

September 1987 month-end tape. Through analysis of the repetitive syntax of these entries and other work, also described in his March 29, 1989 report, Mr. Difede was able to tie these entries to two programs, FIX and COMFIX, which were dated as having been developed in October 1987 and which appeared for the first time in that month's backup tape. His analysis also determined that they were run prior to month-end in October 1987.

Although the authors of the FIX and COMFIX programs (shown on the tapes to be Irene Ward and Brian Hall, respectively) technically could have used and then erased these programs prior to October 1987 month-end, they did not. Instead, UES allowed the programs to remain on the system and be copied on to each month's backup tape through December 1988. Neither the Trustee's consultants nor CMSC have found any evidence that UES data processing personnel wrote other computer programs capable of falsifying due diligence entries and then erased them from the UES computer system.

As Mr. Difede previously reported to ED, he also compared all existing readable month-end tapes for November 1987 through June 1988 to each previous month-end tape and found no additional fictitious due diligence entries other than those caused by FIX and COMFIX.

Mr. Difede's analysis of the UES system determined that the system automatically recorded the date of each amendment to any program, like FIX and COMFIX. No such amendments were found to FIX or COMFIX after they were each run in October 1987. In addition,

addition, no purpose would have been served in running these programs a second time in their present form. Each program is designed to search for missing due diligence entries and fill all voids found. Once any such voids are filled through one run of each program, a second run would find no void and, therefore, make no additional entries.

UES' month-end tapes from July 1986 through August 1987 have not been found, or were unreadable or incomplete and thus unusable. However, while the more rigorous Department of Education due diligence regulations went into effect in March 1987, the due diligence cycle for such loans would not cause those loans to begin to be claimed until approximately October 1987, when FIX and COMFIX were run.

Mr. Difede's search for month-end tapes was affected by apparently sloppy maintenance of tapes by UES. However, neither Mr. Difede nor the Trustee is aware of any information indicating that any such tapes were destroyed or withheld by UES. While it is theoretically conceivable that individual programers formerly employed by UES could have maintained program libraries on tape not available to anyone else, such a practice would have been unusual in the industry and neither the Trustee nor CMSC have found any evidence that such libraries ever existed at UES.

2. Transfer/Copying Of UES Database Tapes To The Trustee.

After the Trustee gained access to the UES facility in November 1988, the Trustee's counsel spent several weeks identifying and inventorying documents maintained in numerous files throughout the facility. This process consumed weeks of time, both because of the volume involved and the need to avoid disruption of the ongoing servicing operation being performed by CMSC. At about this time the Trustee's counsel learned that 14 tubs containing about 200 UES month-end database tapes, which were needed for Mr. Difede's work, were available at UES, Inc. A request was made by the Trustee's counsel to UES' counsel for access to the tapes; after some delay on the part of UES' counsel -- which seemed to be the result of overly careful lawyering -- UES willingly furnished the tapes for copying. The copying was completed in about mid-May 1989; the process was slowed by the need for copying the tapes in batches and in a way to maintain their integrity. Copying a single month-end back-up file took approximately 6-8 hours of copying time.

Subsequently, counsel for the Trustee determined to review a substantial number of additional tapes (not month-end tapes) at UES, from a universe of 3,784 such tapes. UES was cooperative in making these tapes available for copying, but delays ensued for two reasons. First, wholesale copying of all the tapes was expensive (estimates were in the $50,000 to $60,000 range) and there was a dispute as to whether UES was obliged to pay for such copying. Second, the Trustee spent some time trying to re-identify the 200 tapes previously copied and since returned to UES, so that there would not be unnecessary duplication of copying. Eventually, the Trustee elected to copy all of the tapes (3,984) at its expense.

3. Inspector General Request For Access To UES Database Tapes.

On July 17, 1989, the IG's office first requested copies of the UES month-end database tapes, for the months of May 1986 through December 1988. The IG requested that the Trustee mail some descriptive file documentation for its review and on July 25 the Trustee mailed UES database directory listings and file layout descriptions of sample files for month-end October, 1987 on two tapes. In early August 1989, however, the IG reported that it had not been able to read the tapes which were delivered. Ultimately it was discovered that the IG's computer contractor (Boeing) had physically damaged the tapes. To remedy the situation, the Trustee re-created those tapes and mailed the additional copies to the IG. Shortly thereafter, the Trustee prepared for the IG a memorandum describing the file structure for the tapes covering the period March 1987 through September 1987 and identifying the reformatting of the month-end tapes necessary to render them readable on the IG's computer system. After reviewing the memorandum, the IG reported that it did not have the resources to make these files usable. At the Trustee's request, Mr. Difede therefore accomplished the reformatting that made the files readable by the IG.

On August 30, 1989, a partial shipment of the reformatted tapes that had been requested by the IG was mailed. Unfortunately, however, Federal Express lost those tapes in the mail and they never arrived at the IG's office. On September 14, 1989, a second shipment of those tapes was sent to ED. On October 3, 1989, the final copies of all of the requested tapes that were available and usable were sent to the IG.

On October 10, 1989, the IG informed the Trustee that it was having problems reading the tapes and that files appeared to be missing. The Trustee's analysis of the problem revealed that the operational employees who had been directed to copy the tapes had used improper procedures and only copied the first file on a tape, even when more files existed. Accordingly, all of the tapes were properly recopied and shipped to the IG on November 6, 1989. The transmittal letter for the replacement tapes identified the specific month-end tapes which were being provided and those which could not be provided. The chart attached hereto as Exhibit A identifies, for each month for which a tape has not been provided to the IG, the specific reason for its omission.

On December 11, 1989, in a meeting with Mr. Difede attended by Agents Hiller and Mitchell and counsel for the Trustee, the IG asked for an index of all UES tapes that have been made available to the Trustee. That index is being prepared and will be provided to ED under separate cover by January 12, 1990.

CONCLUSION

The Trustee has attempted to cooperate to the fullest extent possible with the Inspector General's staff and their investigation of UES servicing at substantial expense. All available, readable and usable UES month-end data based tapes have been shared with the Inspector General. The Trustee's analysis of this information, which has also been shared with ED, has found no evidence of any UES computer programs designed to enter fictitious due diligence records on loans serviced by UES other than the FIX and COMFIX programs. The Trustee's analysis has also concluded that those programs were run only in October of 1987. However, if the Inspector General or ED desire additional information about the UES month-end data base tapes, the Trustee remains available for further discussion with the Inspector General's staff at its request.

EXHIBIT A

REASON THAT MONTHLY UES DATABASE TAPES WERE NOT PROVIDED TO THE DEPARTMENT OF EDUCATION

Month	Reason
07/86	Unable to locate production data base files from archives.
08/86	Unable to locate production data base files from archives.
09/86	Unable to locate production data base files from archives.
10/86	Unable to locate production data base files from archives.
11/86	Unable to locate production data base files from archives.
12/86	Tapes are available, media errors render them unusable.
01/87	Unable to locate production data base files from archives.
02/87	Unable to locate production data base files from archives.
03/87	Unable to locate production data base files from archives.
04/87	Unable to locate production data base files from archives.
05/87	Unable to locate production data base files from archives.
06/87	Unable to locate Volumes 1, 2, 3 from archives.
07/87	Tapes are available, media errors render them unusable.
08/87	Tapes are available, media errors render them unusable.
02/88	Tapes are available, media errors render them unusable.
08/88	Tapes are available, media errors render them unusable.

State of California

Senate Permanent Subcommittee
on Investigations

Memorandum

EXHIBIT # 35-A

JAN 8 [illegible]

To : G. W. McDONALD (LA)
Assistant Commissioner
Enforcement Division

Date : January 7, 1988

File No.: ALPHA

Subject: FIRST INDEPENDENT
TRUST COMPANY
("FITC")

From : **Department of Corporations**
MARK J. BRECKLER (SF) MJB
Senior Trial Counsel
Enforcement Division

In February, 1987 the Enforcement Division received information from the State Banking Department ("Banking") concerning First Independent Trust Company ("FITC") of Sacramento and its Trust Rate Program. FITC is licensed as a trust company with Banking. FITC, through its Trust Rate Program, purports to offer a beneficial interest in various financial instruments including government-guaranteed student loans. The exact nature of the transaction and FITC's relationship with investors/depositors in the Trust Rate Program is not entirely clear from the materials we have to date.

In January, 1987 Banking asked our Office of Policy to review the FITC Trust Rate Program and opine whether the Program constituted the sale of securities in violation of the Corporate Securities Law of 1968. Larry Krieg reviewed certain materials and concluded in a letter to Banking that the Trust Rate Program constituted the sale of securities, not exempt from the qualification requirement. A copy of Larry Krieg's letter of January 27, 1987 to Banking is attached.

Since February, 1987 we have discussed this matter with Banking on several occasions. From the beginning, Banking has asked that we not proceed with a formal investigation of this matter so that it could attempt to resolve its problems with FITC, its licensee, either through informal agreements with or through administrative action against FITC. Because of Banking's request, and since we have not received a complaint from any FITC investor, we have not opened our own formal investigation. However, to date Banking has not taken any formal action against or otherwise resolved its problems with FITC. As recently as January 6, 1988 Banking requested that we still not proceed with a formal investigation of FITC's Trust Rate Program, hoping that they could still reach a satisfactory resolution with FITC.

I believe that at this point, we need to approach Banking and request a more formal statement from them about their position regarding FITC. Thank you.

MJB:dbv

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State of California

Memorandum

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 35-B

To : HOWARD GOULD
Superintendent of Banks
Department of Banking
235 Montgomery Street, Suite 750
San Francisco, CA 94104-2980

cc: Mark J. Breckler, Senior Trial Counsel
Department of Corporations (SF)

Date : January 12, 1988

File No.: ALPHA

Subject: FIRST INDEPENDENT
TRUST COMPANY (FITC)

From : Department of Corporations

G. W. McDONALD
Assistant Commissioner
Enforcement Division

Attached is a memo to me from Mark Breckler of our San Francisco office. He has been informally coordinating with Jim Carrig of your staff on this matter.

Mark and I are getting concerned about the potential embarrassment and criticism we would come under if this institution goes under. Our Office of Policy concluded a year ago that they may be selling unqualified securities, but we have failed to follow up with further investigation or enforcement action in deference to Jim's request that we hold off.

Would you talk to your people on this and let me know 1) whether FITC is in any danger of going under, 2) whether your Department is likely to resolve your differences with them informally or by public enforcement action in the near future, and 3) whether there is any reason why we shouldn't go ahead with our investigation and/or possible enforcement action relating to the securities issues?

Please give me your thoughts on this at your earliest convenience. Thanks.

GWM:dcs
Attachment

OFFICE OF THE
SUPERINTENDENT OF BANKS

[illegible] MONTGOMERY STREET
SUITE [illegible]
SAN FRANCISCO [illegible]
[illegible]

GEORGE DEUKMEJIAN
GOVERNOR

State of California
STATE BANKING DEPARTMENT
Sacramento, California

600 SOUTH
COMMONWEALTH AVENUE
SUITE [illegible]
LOS ANGELES [illegible]
[illegible]

1107 NINTH STREET
SUITE [illegible]
SACRAMENTO [illegible]
[illegible]

110 WEST "C" STREET
SUITE 1010
SAN DIEGO [illegible]
[illegible]

August 18, 1987

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 36

Mr. Deno Evangelista
Chairman of the Board and President
First Independent Trust Company
1020 - 12th Street
Sacramento, CA 95814

Dear Mr. Evangelista:

This is to follow on certain points which were raised at the meeting of August 11, 1987, and for which we agreed to provide you specific documents in order to facilitate your response.

At the meeting, we pointed out that in reviewing the file for trust account No. 407-21364 during the examination of First Independent Trust Company as of November 17, 1986, our examiners found documents that purported to be photocopies of investment authorizations signed by the trustor. However, as noted in the Report of Examination, it appeared that, in the case of each photocopy, the trustor's signature had been photocopied from a single signature and the text of the investment authorization had been typed in above the photocopy of the signature. Also, as noted in the Report of Examination, Jon D. Smock informed the examiners that the documents in the file were only file copies and were not intended for use as authorizations by the trustor. When we raised the matter at the meeting and expressed concern that, although the documents purported to be photocopies of investment authorizations signed by the trustor, it appeared that there actually were no such investment authorizations signed by the trustor, Mr. Smock stated that the examiners might have misunderstood the Company's filing system and that, while any particular file might contain photocopies, the originals might be in another file. Also, you explained that the Company has a new authorization from the trustor.

As we agreed at the meeting, we are attaching, copies of the photocopies to which we referred, (Exhibits A-1 through A-6). It is requested that the Company locate the original authorizations in its files and make them available for inspection by our examiners.

Also, we are attaching, a copy of a document which purports to be a photocopy of another authorization signed by the trustor, (Exhibit B). As you will see, the signature of the trustor on Exhibit B is quite different from the signature on Exhibits A-1 through A-6. It is requested that the Company explain the difference in signatures.

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Mr. Deno Evangelista
August 18, 1987
Page Two

In addition, at the meeting, we pointed out that, by letters dated December 19, 1986, January 14, 1987, and February 6, 1987, we called upon the Company to provide a list of the accounts with respect to which you had primary control of the files and were the primary contact officer with the customers. When we first raised this matter at the meeting, Mr. Smock replied that the Company had resolved the matter with the examiners at the exit meeting at the end of the examination or perhaps during a visitation after the examination. We have reviewed the matter with the examiners and have confirmed that the call for the list of accounts is still outstanding. As discussed at the meeting, we must ask, therefore, that the Company provide the list of accounts as called for.

To simplify your response to these items, we will arrange for a Department examiner to visit the Company's Carmichael Branch at 5325 Engle Road, Carmichael, on Friday, August 21, 1987 at 2:00 p.m., to inspect the original authorizations for trust account No. 407-21364 to receive the explanation regarding the differences in signatures, and to receive the listing of accounts.

Very truly yours,

HOWARD GOULD
Superintendent of Banks

By F. Carrig
JAMES F. CARRIG
Chief Counsel

JFC:aee
Enclosures

cc: Jon D. Smock, Esq.
John M. Gregory, Esq.
State Banking Department, Sacramento

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 41-A

DENO EVANGELISTA
3512 Norris Avenue
Sacramento, California 95821

October 19, 1990

Honorable Sam Nunn, Chairman
Permanent Subcommittee on Investigations
100 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Nunn:

In my earlier correspondence and testimony before your subcommittee, I described some of the problems that I and FITCO experienced with the State Banking Department since the time that the bank obtained its charter by court order.

The enclosed declaration describes in some detail the events leading up to the necessity for my having to go to court to obtain the authorization to do business in California.

Once again, thank you for the opportunity to appear before your subcommittee and testify on my and FITCO's behalf. If you have any further questions, please feel free to contact me.

Sincerely,

Deno Evangelista

DENO EVANGELISTA

DECLARATION OF DENO EVANGELISTA

I, Deno Evangelista, declare:

1. I am Founder, President, and Chairman of the board of First Independent Trust Company and that I have personal knowledge of the facts stated herein and if called as a witness I could and would testify competently thereto.

2. This declaration demonstrates what I believe to be a pattern of harassment, unfair dealings, arrogance, and illegal activities systematically conducted by the CALIFORNIA STATE BANKING DEPARTMENT (hereinafter "BANKING DEPARTMENT").

3. This declaration is designed to describe a history of the relationship between myself and said BANKING DEPARTMENT from late 1972 to August 7, 1975. On this date the Superior Court of California, County of Sacramento issued the Peremptory Writ of Mandamus.

4. My first encounter with the BANKING DEPARTMENT begins in late 1972, in an effort to obtain information and guidance to establish an independent full-service commercial bank to service the small and medium-sized accounts.

5. Accordingly, I visited the BANKING DEPARTMENT office in San Francisco. Upon my arrival, I met with Mr. John Sherman, Chief Deputy Superintendent of Banks and Mr. Fred Hillebrandt, Deputy Superintendent of Banks. My inquiries and concerns regarding the establishment of an independent commercial bank were responded to with remarks of discouragements, with answers that were confusing, negative, or no answer at all. Mr. Sherman or Mr. Hillebrandt stated that "Sacramento is well served at

every corner by Bank of America or Crocker Bank." I departed the office feeling that what I had received was government bias.

6. The discouraging attitudes and comments of the two senior officers of the BANKING DEPARTMENT established firmly that if I were to succeed, the application should be "more than well prepared." After more research, I determined that an independent banking institution was indeed real, defendable and in the best interest of the community it was to serve. I again revisited the BANKING DEPARTMENT in San Francisco, I explained to the receptionist that I had had a prior meeting and requested an audience with either or both Mr. Sherman or Mr. Hillebrandt. I was informed that neither of the two were available for the entire day.

7. Approximately thirty (30) days later I revisited the BANKING DEPARTMENT's office and asked for Mr. Fred Hillebrandt and was told that Mr. Hillebrandt was not available. At my insistence, I was finally introduced to a gentleman and we talked for approximately one hour. I never got the same answer twice and I departed knowing my questions fell on deaf ears.

8. It was now very clear to me that a license to establish a full-service commercial bank under the present administration would never be issued. I then concluded that an application for a trust banking business would be better received, there being no independent trust companies in Northern California. Such application, filed as prescribed under current law, could not, or

should not be denied.

9. A substantial portion of the application, in accordance with the trust banking laws, had been prepared by me. However, realizing that an aura of rancor was present, I decided to obtain the assistance of my Los Angeles attorney, Mr. John B. Sobieski, to assist in moving the application successfully forward.

10. Mr. Sobieski arranged for a conference with Messrs. Sherman and Hillebrandt at the San Francisco office on April 10, 1973. There our plans were discussed in detail and we were told that an application should particularly demonstrate a "need" for the trust company with emphasis on personnel and benefits to the community.

11. Mr. Sobieski, Mr. Chris Marelia (an attorney and our to-be-Senior Trust Officer) and myself conferred with Mr. Hillebrandt at the Superintendent of Banks' office in San Francisco on September 10, 1973. We received a formal application with a comment that, "the BANKING DEPARTMENT" would act promptly after the application was filed."

12. A formal application was filed dated December 28, 1973. In reference to my application, in a letter dated June 12, 1974, the BANKING DEPARTMENT wrote me:

> "The Superintendent of Banks regrets to inform you that your request . . . is hereby denied."

13. On June 25, 1974 attorneys Mr. Jay Gould and Mr. John

Sobieski, and I conferred with Superintendent of Banks Donald Pearson at his San Francisco office. Superintendent Pearson stated that the reasoning behind his denial was that, if the trust departments of the major banks in Sacramento were not profitable, then how could the applicant be? And he gave us the following choices: (1) Abandon the idea; (2) Refile; (3) Apply for a federal charter; or (4) Seek judicial review.

14. We argued for a rehearing. Superintendent Pearson stated that a rehearing was not a BANKING DEPARTMENT practice, but that if a Petition for Rehearing were filed, he would submit it to his legal advisors.

15. A petition for Rehearing was filed on July 26, 1974. Accompanying the Petition for Rehearing were approximately ninety-seven (97) letters from attorneys, associations, corporations, commercial banks and prominent Sacramento citizens requesting that the Superintendent's denial of the application be reconsidered and that a license be issued.

16. On September 4, 1974, a conference was held with Superintendent Donald Pearson in San Francisco. It was pointed out at this conference that we strongly believed that the additional evidence in the Petition for Rehearing conclusively showed the application should be granted. Superintendent Pearson refused to address the question of a rehearing, but stated that he would advise us by September 29th, or the early part of October, 1974 of their decision on the rehearing.

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17. On November 1, 1974, Mr. Sobieski phoned Attorney Carrig in San Francisco and told him about the letter that Superintendent Pearson had promised on September 4, 1974, as to whether the matters in the petition for rehearing would have made any difference in their decision. Mr. Carrig said it was his fault, not Pearson's, that Mr. Carrig had been told to write the letter, but he had been busy revising rules -- which had a deadline -- so the letter was delayed and that he would write it now.

18. By letter date November 1, 1974, I was informed by Mr. James F. Carrig, Counsel for the BANKING DEPARTMENT:

> "As you know, the application was denied on June 12, 1974. Following the denial, you submitted additional materials in support of the application and requested that the Superintendent reconsider the denial of the application. . . .
>
> "The additional material that you submitted have now been reviewed, and we regret to inform you inform you that the Superintendent has determined that, if he had had the additional materials in hand before deciding the application, he would still have denied the application."

19. The record shows that the only trust companies in the

Sacramento area were the trust departments of the "chain" banks, with headquarters outside Sacramento. The 97 letters on file with the Superintendent attested to the fact that "the public convenience and advantage would be promoted . . ." Mr. Norman Powell, Examiner of the BANKING DEPARTMENT, commented on these letters as follows:

"The survey by the examiner discloses that Mr. Evangelista and Mr. Marelia were not well known in the banking and trust circles."

If this were so, then letters from firms of attorneys and accountants, plus business leaders and others, would have constituted false and misleading information to a California State Agency. I do not believe that these distinguished Sacramento citizens would have written misleading letters. These letters team with evidence to reveal that Mr. Marelia was well known and highly respected. As for myself, I was the most requested speaker with the Sacramento Chamber of Commerce, speaking at that time on "The History of Money" and "The European Common Market."

20. I reviewed all of my work to insure accuracy and data and discovered that while I had many of the BANKING DEPARTMENT's annual reports for the fiscal year ends, I did not have the reports for the fiscal years ending 1972/73 and 1973/74.

21. The frustration between the BANKING DEPARTMENT and myself was at the highest level possible and it was my belief

that making any more inquiries would create additional animosity. Therefore, I conversed with California State Assemblyman Z'Berg of the bureaucratic problems which existed in the BANKING DEPARTMENT and the BANKING DEPARTMENT's failure to file statutory required reports of activities of the State's banks for the previous two (2) years.

22. Assemblyman Edwin Z'Berg wrote a letter to the BANKING DEPARTMENT, resulting in substantial publicity through United Press International (UPI). While Assemblyman Z'Berg made a sound political point, the December 7, 1974 UPI publicity created an irreparable condition between the BANKING DEPARTMENT and myself which existed throughout the life of FIRST INDEPENDENT TRUST COMPANY.

23. At a meeting in the San Francisco office of the BANKING DEPARTMENT, Mr. Sherman alluded to Mr. Marelia's age in a manner that inferred that maybe the application would be more favorably received if we had a younger man. In order to avoid further antagonism, I agreed to engage the services of a younger Trust Officer. As a consequence, I received a letter dated April 24, 1975 from Mr. Raymond A. Valine, affirming that he would agree to work as a Trust Officer if the application was granted. In a letter dated May 5, 1975, I advised the Superintendent of Banks that the applicant would not use the investment advisory services of Securities Supervision Corporation and of the acceptance by Mr. Valine of the position of Trust Officer.

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DECLARATION OF DENO EVANGELISTA
Page 8

24. At a subsequent meeting in the San Francisco office of the BANKING DEPARTMENT, a serious argument arose concerning the AMOUNT OF REQUIRED CAPITAL necessary to establish a Trust Company. We were prepared to contribute twice the amount required by statute. However, Superintendent Pearson insisted that this amount was insufficient.

25. Numerous attempts were made by myself, individually, and with counsel, to convince the Superintendent of Banks that he, indeed, had jurisdiction for a rehearing on the matter. Since no definitive action was taken by the Superintendent which would have benefited my application processing, on November 3, 1974, Mr. Archibald Mull, my Sacramento attorney, sought a mandatory injunction from the Sacramento Superior Court.

26. The BANKING DEPARTMENT AND ITS COUNSEL would never forget, nor forgive the months and years of confrontation (See Exhibit A), the Writ of Mandamus (See Exhibit B), and the United Press International (See Exhibit C). FIRST INDEPENDENT TRUST COMPANY WAS TO BE TREATED WITH INDIFFERENCE.

I declare, under penalty of perjury, that the foregoing is true and correct and that this declaration is executed in Sacramento, California this 3rd day of August 1989.

Deno Evangelista

Deno Evangelista

LEGISLATIVE ADDRESS
STATE CAPITOL
SACRAMENTO 95814
TEL.: 445-8360

DISTRICT OFFICE
218 E STREET, SUITE C
DAVIS, CA 95616
916—758-8610

CITY HALL
1000 WEBSTER STREET
FAIRFIELD, CA 94533
707—[illegible]

Assembly
California Legislature

EDWIN L. Z'BERG
MEMBER OF ASSEMBLY, FOURTH DISTRICT
CHAIRMAN
RESOURCES AND LAND USE COMMITTEE

COMMITTEES
CHAIRMAN, RESOURCES AND LAND USE
PUBLIC EMPLOYEES AND RETIREMENT
WAYS AND MEANS
SUBCOMMITTEE ON COASTAL RESOURCES
SUBCOMMITTEE ON WATER

MEMBER
CALIFORNIA COMMISSION ON UNIFORM STATE LAWS
WESTERN STATES FOREST INDUSTRIES TASK FORCE
WILDLIFE CONSERVATION BOARD

EX: A

August 14, 1975

Mr. Deno Evangelista
Lawyers Financial Corporation
3001 Arden Way
Sacramento, California 95825

Dear Deno:

I got my weekly bulletin from the State Banking Department and lo and behold right at the top of it, it indicated that the new proposed trust company of Deno Evangelista has been approved.

Does this mean that finally you are making headway against the bureaucracy!

Regards,

Ed

EDWIN L. Z'BERG

ELZ:pm

SUPERIOR COURT OF CALIFORNIA, COUNTY OF SACRAMENTO

LAWYERS FINANCIAL CORPORATION,
a California Corporation,

Petitioner,

vs.

JOHN H. SHERMAN, Chief Deputy Superintendent of Banks, State Banking Department, State of California,

Respondent.

NO. 252098

PEREMPTORY WRIT OF MANDAMUS

EX:
B

THE PEOPLE OF THE STATE OF CALIFORNIA

TO: JOHN H. SHERMAN, as Chief Deputy Superintendent of Banks, State Banking Department, State of California, Respondent

Judgment having been entered in this action, ordering that a peremptory writ of mandamus be issued from this Court,

YOU ARE HEREBY COMMANDED immediately on receipt of this writ to set aside the decision of June 12, 1974, denying the application of petitioner for authority to organize and establish a corporation to engage in the trust business at 1020 - 12th Street, City of Sacramento, County of Sacramento, State of California, under the name of "First Independent Trust Company", which application is hereby remanded to you, and to take further action on the application in accordance with law.

Dated: August 7, 1975.

JAMES A. SIMPSON, ACTING COUNTY CLE

By ______________
Deputy Clerk

LET THE FOREGOING WRIT ISSUE.

Dated: August 7, 1975.

____
Judge of the Superior Court

EX:
C

Department of Banking Fails to File Reports

Second Page 1
Saturday, December 7, 1974—A3

United Press International

The State Department of Banking has failed for two years to issue reports on the financial condition of California banks as required by law, it was learned Friday.

Donald Pearson, superintendent of banks, said the delays were due to internal problems, misunderstandings, staff shortages, and computer-related foulups.

Pearson said the annual reports on banks for the fiscal years 1972-73 and 1973-74 were sent to the state printer, but a spokesman in that office said it received only one report.

State law directs the department to submit a report annually after the close of each fiscal year June 30. The report concerns the fiscal condition of the state's multi-billion dollar banking industry, information on national banks, and operations of the State Department of Banking.

Pearson said the reports didn't contain anything "startling" or "new or dramatic" and "it was simply a job" of compiling information which was already public.

But, veteran Assemblyman Edwin Z'berg, D-Sacramento, a member of the powerful Ways and Means Committee, disagreed.

"I have written a letter to the department asking for the reports," Z'berg said. "I think it is of the utmost importance, especially in a period of great economic concern, to know the financial conditions of our banks."

The report, Pearson told UPI in an interview, receives wide circulation and is sent to the governor, the Legislature, banks and libraries.

A spokesman in the State Printer's Office said the 1972-73 report was received on Nov. 19, and the second report had not been received.

Deputy Superintendent of Banks Fred Hillebrandt said the second report was sent to the printer "a week or 10 days ago from Los Angeles" and that might account for its absence.

"Well, you are talking about a situation in which we had to feed all this financial information into a computer," said Pearson when asked about the delay. "It required dealing with tremendous problems as they came up. We got those problems behind us.

"I'm not going to say we didn't have any internal problems over here," he said. "I did do some reassignment of responsibilities just to make sure that we were going to get some of these things out in better shape."

He said assembling the information with the department's "short staff" caused "serious internal problems."

Asked what might happen to him for not complying with the statute, he said, "I'm sure the penalties are whatever the governor or the Legislature wants to do."

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SENATE PERMANENT
SUBCOMM ON INVESTIGATIONS

OCT 0[illegible] 1990

MAJORITY OFFICE

**Senate Permanent Subcommittee
on Investigations**

EXHIBIT # 41-B

DENO EVANGELISTA
3512 Norris Avenue
Sacramento, California 95821

October 2, 1990

Honorable Sam Nunn, Chairman
Permanent Subcommittee on Investigations
100 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Nunn:

Thank you for the opportunity to appear before your subcommittee last week. In that hearing, I was asked the name of the Washington, D.C., lawyer retained by First Independent Trust Company in connection with the 1986 amendments to the Higher Education Act. I did not recall it at the time, but his name is Timothy D. Naegele, whose address and phone at that time was Law Offices of Timothy D. Naegele & Associates, International Square, 1850 K Street, N.W., Suite 1280, Washington, D.C. 20006, (202)466-7500.

You also asked me to provide a record of the compensation I received from FITCO. All records of that nature are in the possession of the State Superintendent of Banks, and by letter of this date (copy enclosed) I have asked the Superintendent to provide that information to me so that it may be forwarded to you.

You were kind enough to leave the record open for me to respond in greater detail to some of the statements about FITCO made at the hearing. I very much appreciate that opportunity and shall do so under separate cover within a reasonable time.

Sincerely,

Deno Evangelista

DENO EVANGELISTA

DENO EVANGELISTA
3512 Norris Avenue
Sacramento, California 95821

October 2, 1990

Mr. James E. Gilleran
Superintendent of Banks
State Banking Department
1107 Ninth Street, Suite 330
Sacramento, California 95814

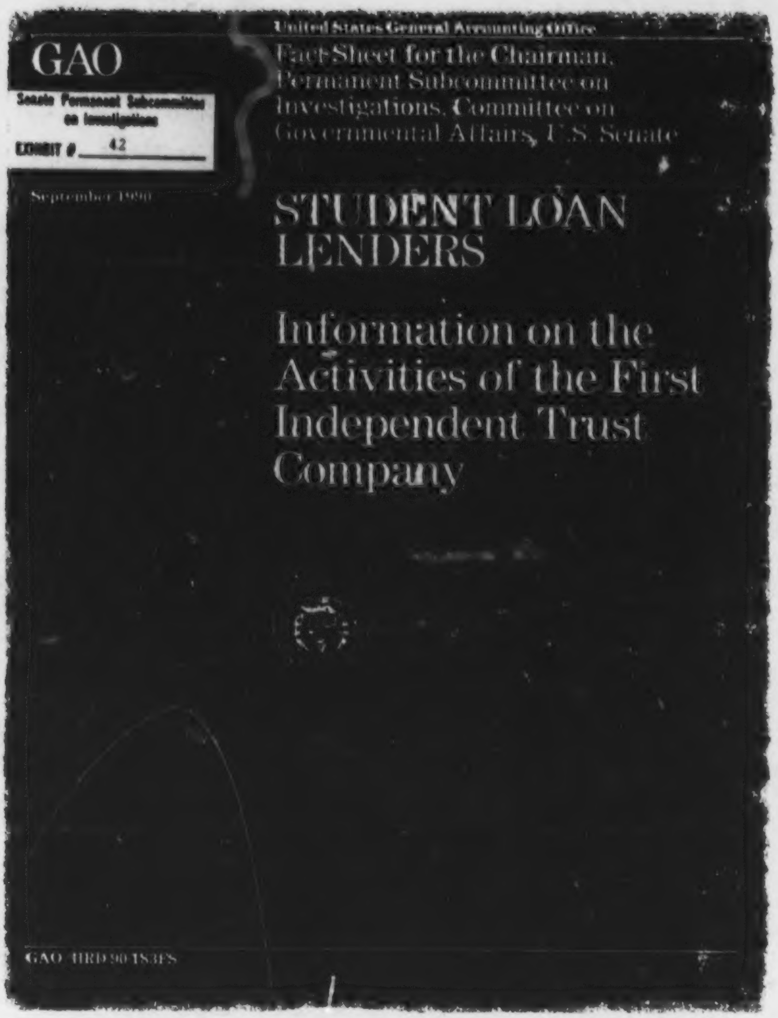
Dear. Mr. Gilleran:

At the hearing in Washington, D.C., last week, Senator Nunn asked me to provide a record of the compensation I received from FITCO. All such information is in your hands. Therefore, I shall appreciate your providing me with a year-by-year record of my compensation received from FITCO, together with a similar record of my frequent contributions to capital. Thank you in advance for your expected cooperation in complying with this request.

Sincerely,

Deno Evangelista

DENO EVANGELISTA



United States General Accounting Office

GAO

Senate Permanent Subcommittee on Investigations

EXHIBIT # 42

Fact Sheet for the Chairman, Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

September 1990

STUDENT LOAN LENDERS

Information on the Activities of the First Independent Trust Company

GAO/HRD-90-183FS

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-241253

September 25, 1990

The Honorable Sam Nunn
Chairman, Permanent Subcommittee
on Investigations
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request for information on activities of the First Independent Trust Company (FITCO) of Carmichael, California. FITCO made loans to students participating in the Stafford Student Loan Program until California's State Banking Department closed it in May 1989. Specifically, you requested information describing the chronology of events from when FITCO began and ceased operations and afterwards. In addition, you asked that we (1) analyze FITCO's loan portfolio, (2) determine whether it owed monies to the Department of Education, and (3) summarize the audits and reviews of FITCO conducted by various organizations.

On September 19, 1990, we discussed the results of our work with your office. This fact sheet summarizes the information provided at that meeting.

Background

The Stafford Student Loan Program, formerly called the Guaranteed Student Loan Program, consists of three types of loans: Stafford loans, Parent Loans for Undergraduate Students (PLUS), and Supplemental Loans for Students (SLS). These types of loans differ somewhat in their terms and conditions (see app. I), but each is guaranteed by state or private nonprofit guaranty agencies against borrowers' death, disability, bankruptcy, and default. Banks, credit unions, and savings and loan associations are the primary providers of student loans. The federal government reinsures the guaranty agencies against death, disability, bankruptcy, and default.

Lenders participating in this program generate revenue by earning interest and receiving from the Department of Education a special allowance payment—to assure that student loans provide close to market rates of return. For Stafford loans (but usually not SLS and PLUS loans) federal interest payments are generally made while the student remains in school and afterwards for a grace period,[1] and then the borrower becomes responsible for principal and interest payments. In contrast, the special allowance payment is paid to the lender throughout the life of the loan. Lenders can file quarterly for their interest subsidy payments.

From Stafford loan borrowers, lenders collect a 5-percent origination fee, which is deducted from each loan disbursement made to the borrowers. SLS and PLUS loans are not subject to these fees. The fee is remitted to the Department to help offset the government's cost of subsidizing these loans. In addition, lenders can collect an insurance premium of up to 3 percent from each loan disbursement, regardless of the type of loan. The premium is remitted to the guaranty agencies to help offset their administrative costs.

FITCO has made all three types of student loans. Its primary practice was to sell the loans it originated to a secondary market quickly,[2] often within a few days of their origination. FITCO could then use these loan proceeds to make new loans.

Scope and Methodology

As agreed with your office, we obtained the requested information primarily by interviewing and reviewing records provided by officials of the (1) California State Banking Department, (2) Department of Education headquarters and its San Francisco regional office (region IX), (3) California Student Aid Commission (CSAC), and (4) Higher Education Assistance Foundation (HEAF). We also spoke with and obtained documents from several other organizations that serviced or otherwise were involved in handling FITCO loans.

CSAC and HEAF guaranteed almost all the loans FITCO made and gave us a statistical analysis of the loans FITCO disbursed by fiscal year, type of loan, and kind of school borrowers attended. We analyzed loan information by grouping the schools in two categories—proprietary and nonproprietary.[3] We did not independently verify the information CSAC and HEAF provided.

---

[1] Generally between 6 and 12 months after a student leaves school.

[2] A lending institution that purchases guaranteed student loans from originating lenders to provide them funds to make new loans.

[3] CSAC provided us with information for its loans disbursed by nine types of schools. We used its category "vocational profit-making" to show proprietary schools, and combined the remaining eight types of schools to compute nonproprietary school information.

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Our work was conducted between May and September 1990 in accordance with generally accepted government auditing standards.

Chronology of Events

Appendix II presents information on selected milestones in FITCO's activities, beginning with its start-up in September 1975, covering events leading to its closing in May 1989, and ending with a lawsuit the California Banking Department filed against FITCO's former officers in June 1990. Appendix II also includes the dates when CSAC and HEAF began guaranteeing FITCO's loans, 1979 and 1986, respectively, and highlights when FITCO was notified of possible problems concerning its operations.

Portfolio Analysis

During the 11 years FITCO was in the Stafford program, it made over $1 billion in loans that were guaranteed by CSAC and HEAF. Table 1 shows the amount of loan disbursements that were guaranteed by CSAC and HEAF, most of which were for Stafford loans.

Table 1: Net Disbursements by Type of Loan for CSAC and HEAF

Dollars in millions

	Guaranty agency	
Type of loan	CSAC	HEAF
Stafford	$383.6	$379.0
PLUS	17.7	10.7
SLS	118.1	179.0
Total	$519.4	$568.7

Most of FITCO's loans were made to students attending proprietary schools. Table 2 shows that $355.2 million (68 percent) of the $519.4 million in loans guaranteed by CSAC and $547.1 million (96 percent) of the $568.7 million in loans guaranteed by HEAF were made to students attending such schools.

Table 2: Net Disbursements by Type of School for CSAC and HEAF

Dollars in millions

	Guaranty agency	
Type of school	CSAC	HEAF
Proprietary	$355.2	$547.1
Nonproprietary	164.2	21.6
Total	$519.4	$568.7

Possible Monies Owed to the Department of Education

When a lender files its quarterly bill with the Department for interest and special allowance subsidy payments, the Department offsets any origination fees it is due. For example, if a lender is due $1 million in interest and special allowance and owes the Department $400,000 in origination fees, the Department would pay the lender $600,000. Conversely, if a lender owes more origination fees than interest and special allowance, it should send the Department a check for the difference.

Because FITCO sold its loans to secondary market lenders soon after it made them, it usually owed the Department loan origination fees. At one point, FITCO owed the Department over $13 million in fees from loans originated in 1987. These fees were not paid until April 1988.

Appendix III contains a detailed analysis of the problems FITCO had in keeping current its origination fee payments to the Department. For example, FITCO owed the Department about $5.5 million after it ceased operations in May 1989; however, in March 1990, the Department agreed with the State Banking Department (as the liquidator of FITCO) to settle this debt for $4.4 million. We confirmed through our analysis of the Department's records that FITCO actually owed the Department $5.5 million.

The Department said that it agreed to the $4.4 million amount after considering the litigation risk of pursuing the $5.5 million underpayment (i.e., the probability of prevailing), the resource drain on the federal government needed to pursue the litigation, and the time it would take to receive the $5.5 million. In addition, the Department indicated that the deadline for amending its $4.4 million claim with the State Banking Department had expired.

Summary of Reviews Conducted at FITCO

We identified 21 audits and reviews of FITCO activities conducted during the 14-year period by such organizations as the State Banking Department, the Department of Education, CSAC, and HEAF. (See app. IV.)

Each of the audits and reviews found minor or major deficiencies in FITCO's operations. An example of a minor deficiency was that FITCO failed to use new student addresses, which it knew, to mail delinquency letters. A major deficiency was that FITCO did not timely file its interest billings and owed the Department origination fees, such as the $13 million discussed earlier. In addition, State Banking Department audit reports cited problems in FITCO's financial operations as early as

December 1975 and found generally unsatisfactory conditions as early as November 1976.

As the result of CSAC's and HEAF's last reviews of FITCO in spring 1989, the two guaranty agencies began to terminate their relationship with FITCO. The two agencies found significant problems with FITCO's operations, including not paying the insurance premiums on loans it had made.

As agreed with your office, we did not obtain written comments on this fact sheet. We did, however, discuss its contents with Department of Education program officials and incorporated their comments where appropriate.

We are sending copies of this fact sheet to other congressional committees, the Department of Education, and other interested parties. Should you wish to discuss its contents, please call me on (202) 275-1793. Other major contributors are listed in appendix V.

Sincerely yours,

Franklin Frazier

Franklin Frazier
Director, Education
and Employment Issues

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Abbreviations

CSAC	California Student Aid Commission
FITCO	First Independent Trust Company
GAO	General Accounting Office
HEAF	Higher Education Assistance Foundation
PLUS	Parent Loans for Undergraduate Students
SBD	California State Banking Department
SLS	Supplemental Loans for Students
UES	United Education and Software

Appendix I

Description of the Differences Between the Loan Types Made Under the Stafford Student Loan Program

The Stafford Student Loan Program consists of three types of loans. These loans differ somewhat in their terms and conditions.

Stafford Loans

Stafford loans, formerly called guaranteed student loans, have the largest volume of the three loan types (almost $10 billion in fiscal year 1989) and have been available since the program was created as part of the Higher Education Act of 1965. The loans are based on the student borrower's financial needs. However, borrowers do not have to demonstrate their credit worthiness. Other key facts are

- Interest rates for new borrowers are currently 8 percent for the first 4 years of repayment and 10 percent after that.
- Maximum loan limits are $17,250 for undergraduates and $54,750 for graduate students.
- Borrowers generally have a 6-month grace period after leaving school before repayment begins.

PLUS Loans

These loans enable parents to borrow funds for each dependent student (those who are not generally responsible for their own financial support) enrolled at a school. These loans started in 1981 and are not needs-based. Other key facts are:

- Interest rates are variable and are determined once a year with a ceiling of 12 percent (11.49 percent is the rate now).
- Maximum loan limits for each dependent are $4,000 per year to a total of $20,000.
- Normally no grace period and payment of principal and interest generally must begin within 60 days after the loan is dispersed.

SLS Loans

These loans are available to undergraduates who are generally responsible for their own financial support, and graduate students. These loans started in 1982 and, like PLUS loans, are not needs-based.[1] Also, like PLUS loans, SLS loans usually have the same interest rate and borrowing limits, and have no grace period. However, legislation passed in December 1989 restricted the availability of SLS loans for such factors as the school's borrower-default rate and the borrower's lack of a high-school diploma or a general equivalency degree.

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[1] SLS loans were part of the Auxiliary Loans to Assist Students program before 1986, and had terms and conditions similar to SLS; both are reported by the Department as SLS loans.

Selected Milestones Detailing FITCO's Activities

Table II.1: Timeframe of Selected Events Concerning FITCO

Date	Event
Sept. 2, 1975	FITCO began operations.
1979[a]	CSAC started guaranteeing FITCO loans.
Aug. 1986	HEAF started guaranteeing FITCO loans.
Dec. 1986-Mar. 1987	FITCO set up computer services in 600 schools in 43 states to facilitate processing of loan applications.
Jan. 15, 1987	Memo from Department of Education headquarters to region IX concerning FITCO's late processing of refunds and returned checks and its possible unreasonable time for processing the checks.
Jan. 26, 1987	Region IX recommended a monitoring system to ensure FITCO promptly submitted interest billings and paid origination fees.
Feb. 9, 1987	Region IX notified Department headquarters of its concern about FITCO's practice of supplying schools with personal computers and problems with FITCO's interest and special allowance payments, and origination-fee billings practices.
Mar. 23, 1987	Department notified FITCO to cease providing schools with computers and software to process loans because these actions constituted an improper inducement.
Aug. 5, 1987	The Department notified FITCO that charging schools a computer rental fee of $18.75 per month resolved its concern with this issue.
Apr. 14, 1988	FITCO paid the Department $13,328,471 for its 1987 loan origination fees.
Mar. 3, 1989	FITCO had not been timely in paying insurance premiums to HEAF on thousands of loans. HEAF stated it was willing to allow FITCO a reasonable time to pay insurance premiums in order to reinstate loan guarantees that had been canceled.
Mar. 6, 1989	HEAF notified the California Student Loan Finance Corporation (secondary market) that it may have purchased loans from FITCO that were not guaranteed because FITCO had not paid the insurance premiums.
Apr. 21, 1989	CSAC notified FITCO that it planned to discontinue guaranteeing its loans.
May 1989	The Department notified FITCO that, based on an audit, it owed about $1.1 million for the overpayment of interest and special allowance subsidy payments and an additional $4.4 million in loan origination fees.
May 1, 1989	FITCO stopped making student loans.
May 1, 1989	HEAF notified FITCO that it would no longer guarantee its Stafford, SLS, or PLUS loans.
May 5, 1989	The California State Banking Department (SBD) notified FITCO that more capital would be needed to continue operating.
May 10, 1989	A HEAF official stated that FITCO was inappropriately commingling school tuition refunds with monies used to make new loans or pay insurance premiums to HEAF.

(continued)

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Date	Event
May 11, 1989	HEAF canceled conditional guarantees it previously issued on FITCO loans because of FITCO's nonpayment of insurance premiums
May 12, 1989	HEAF filed suit against FITCO for failure to forward refunds to subsequent holders (secondary market lenders) of loans
May 19, 1989	The Department notified HEAF that reinsurance coverage would be maintained for FITCO-originated loans, if FITCO or current holders of the loans would pay origination fees due
May 19, 1989	SBD closed FITCO
May 31, 1989	HEAF notified SBD that it intended to terminate its relationship with FITCO by not guaranteeing more loans
June 9, 1989	SBD, as liquidator of FITCO, wanted to settle the nonpayment of insurance premiums with HEAF
June 20, 1989	HEAF rejected SBD's offer to pay FITCO's insurance premiums due to HEAF
Oct. 19, 1989	The Department filed its claim and supporting documentation with SBD
Jan. 12, 1990	The Department accepted SBD's offer of $4.4 million in full satisfaction of all of FITCO's unpaid origination fees
Jan. 16, 1990	The Department's Office of Inspector General informed the Department that a consultant for SBD indicated that the claim against FITCO for unpaid origination fees needed to be changed if possible. It reported that FITCO owed origination fees of $5.5 million
Jan. 19, 1990	Department agreed to settle its claim against FITCO for the nonpayment of origination fees for $4.4 million
Mar. 20, 1990	Final agreement between the Department and SBD citing payment of $4.4 million to satisfy all of FITCO's obligations
June 19, 1990	SBD filed civil lawsuit against former officers of FITCO

[a] A CSAC official could not provide GAO with the date that CSAC started guaranteeing student loans

Additional Analysis of FITCO's Remittance of Loan Origination Fees

When FITCO's loan volume increased substantially in late 1986, the Department became concerned that FITCO's cash flow problems might affect its timely payment of loan origination fees because the fees could amount to several million dollars each quarter. In January 1987, a region IX official recommended to Department headquarters that a monitoring system be established to assure that interest billings are submitted promptly and origination fees paid.

Department headquarters replied by suggesting that the regional official monitor FITCO's filings by having FITCO send him a copy of each form 799 when filed.[1] This official could also confirm that the form 799 was eventually processed by requesting copies from Department headquarters.

In late 1987, CSAC reviewers asked for the Department's assistance in reviewing FITCO's interest billing forms. In January 1988, two region IX reviewers went to FITCO, including the official who suggested setting up a monitoring system. They found that FITCO had not remitted to the Department its loan origination fees for any loans originated in 1987. The forms for the first three quarters of 1987 were filed in December 1987, but the Department returned them to FITCO because they were incomplete.

Tables III.1 and III.2 detail the form 799 history for loan origination fees for FITCO's student loans. Table III.1 shows those origination fees for loans FITCO originated itself and covers the period June 1984 through March 1989.

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[1] FITCO filed two form 799s, one for loans it originated directly and another for loans that were originated on behalf of FITCO by United Education and Software.

Table III.1: FITCO's Interest Subsidy Billings With Origination Fees for Loans It Originated (Lender Number 328374)

Form 799 for quarter ending	Date the Department processed form 799	Fees reported and not offset	Cumulative balance until Department was paid	Date Department received payment
06/84	10/28/84	$38,595.99	$38,595.99	
09/84	11/28/84	133,433.05	172,029.04	2/20/85
12/84	02/24/85	223,259.43	223,259.43	
03/85	04/28/85	335,336.77	558,596.20	
06/85	08/01/85	354,850.18	913,446.38	10/01/85
09/85	02/23/86	520,108.94	520,108.94	3/19/86
12/85	03/09/86	679,600.11	679,600.11	
03/86	08/20/86	286,665.79	966,265.90	
06/86	12/31/86	233,479.52	1,199,745.42	
09/86	02/11/87	543,655.24	1,743,400.66	
12/86	07/26/87	1,547,042.48	3,290,443.14	1/17/88
03/87	02/14/88	2,259,380.13	2,259,380.13	
06/87	02/14/88	3,413,841.54	5,673,221.67	
09/87	02/14/88	4,860,694.25	10,533,915.92	
12/87	02/28/88	2,794,555.30	13,328,471.22	4/14/88
03/88	11/27/83	2,252,481.82	2,252,481.82	
06/88	10/06/88	765,961.46	3,018,443.28	
09/88	06/14/89	799,181.13	3,817,624.41	
12/88	08/02/89	413,512.90	4,231,137.31	
03/89	07/10/89	(92,015.64)	4,139,121.67	

In addition to originating loans itself, FITCO had an arrangement with a third party—United Education and Software (UES)[2] —to process loans on its behalf. The interest subsidy billings for these loans also were not filed on time. Table III.2 shows the billing history for FITCO loans processed by UES, including their payment and nonpayment of origination fees.

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[2] UES is a private organization that operated a data system that handled loan servicing and that owns and operates a group of private schools.

Table III.2: FITCO's Interest Subsidy Billings for Loans Processed by UES for FITCO (Lender Number 829077)

Form 799 for quarter ending	Date the Department processed form 799	Fees reported and not offset	Cumulative balance until Department was paid	Date Department received payment
09/84	12/17/86	$137,782.50	$137,782.50	
12/84	12/17/86	214,287.65	352,070.15	
03/85	12/17/86	237,807.65	589,877.80	
06/85	12/17/86	218,790.11	808,667.91	
09/85	12/17/86	81,325.80	889,993.71	
12/85	12/17/86	197,748.26	1,087,741.97	
03/86	12/17/86	218,443.54	1,306,185.51	
06/86	12/17/86	251,206.74	1,557,392.25	8/13/86
09/86	12/17/86	134,364.98	134,364.98	4/30/87
12/86	05/10/87	196,988.93	196,988.93	
03/87	05/03/87	496,130.25	693,119.18	7/23/87
06/87	05/19/88	545,145.70	545,145.70	
09/87	05/19/88	718,551.51	545,145.70	7/18/88[a]
12/87	05/19/88	617,719.84	1,162,865.54	
03/88	06/05/88	242,335.69	1,405,201.23	
06/88	01/05/89	($1,134.76)	1,404,066.47	

[a] FITCO only paid $718,551.51 on the July 18, 1988, payment instead of the full cumulative balance

FITCO paid its origination fees in 1988, after the Department advised it to file subsequent reports on time and noted that its compliance would be closely monitored. However, a CSAC review in early 1989 revealed that FITCO had not filed its forms 799 for 1988 and estimated that FITCO owed the Department about $5.5 million in origination fees for loans originated in 1988.

FITCO filed its forms 799 for loans originated in 1988 and 1989 but did not pay origination fees due. FITCO reported it owed $5.5 million in such fees—$4.1 million for loans it processed and $1.4 million for loans originated by the UES.

The Department settled with SBD (as liquidator of FITCO) in March 1990 for $4.4 million on the outstanding origination fees. The agreement stated that the Department knew that FITCO owed origination fees that may have exceeded $5.5 million.

The Department said that it agreed to the $4.4 mi[illegible] amount after considering the litigation risk of pursuing the $5.5 mi[illegible]on underpayment (i.e., the probability of prevailing), the resource drain on the federal

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government needed to pursue the litigation, and how long it would take to receive the $5.5 million. In addition, the Department indicated that it had already filed its claim with SBD for $4.4 million, and that the deadline for amending that claim had expired.

Chronology of Audits and Reviews Performed at FITCO

Review number	Review date(s)	Who conducted the review
1	Dec. 16, 1975	State Banking Department
2	Nov. 5, 1976	State Banking Department
3	Dec. 9, 1977	State Banking Department
4	May 31, 1978	State Banking Department
5	Nov. 30, 1979	State Banking Department
6	Aug. 29, 1980	State Banking Department
7	Feb. 27, 1981	Department of Education
8	Mar. 31, 1981	State Banking Department
9	Feb. 24-26, 1982	Department of Education
10	Mar. 31, 1983	State Banking Department
11	June 27-29, 1984	California Student Aid Commission
12	July 27, 1984	Department of Education
13	Aug. 31, 1985	State Banking Department
14	Mar. 3-7, 1986	California Student Aid Commission
15	Nov. 17, 1986	State Banking Department
16	Nov. 19, 1987- Jan. 21, 1988	California Student Aid Commission
17	Jan. 27, 1988	Department of Education/ California Student Aid Commission
18	Mar. 1987-May 1988	Department of Education
19	Mar. 31, 1988	State Banking Department
20	Feb. 27-Mar. 24, 1989	California Student Aid Commission
21	Apr. 10-20, 1989	Higher Education Assistance Foundation

Appendix V

Major Contributors to This Fact Sheet

Human Resources Division, Washington, D.C.	Joseph J. Eglin, Assistant Director, (202) 401-8623 Christopher C. Crissman, Evaluator-in-Charge
Los Angeles Regional Office	Revae E. Steinman, Regional Assignment Manager Cheryl L. Gordon, Site Senior Carla D. Brown, Evaluator

Related GAO Products

Supplemental Student Loans: Legislative Changes Have Sharply Reduced Loan Volume (GAO/HRD-90-149FS, Aug. 3, 1990)

Financial Problems in the Stafford Student Loan Program (GAO/T-HRD-90-52, July 27, 1990)

Guaranteed Student Loans: Credit Bureau Reporting Practices by Guaranty Agencies and Lenders (GAO/HRD-90-71BR, Apr. 9, 1990)

Supplemental Student Loans: Who Are the Largest Lenders? (GAO/HRD-90-72FS, Feb. 21, 1990)

GAO Views on the Stafford Student Loan Program (GAO/T-HRD-90-13, Feb. 20, 1990)

Supplemental Student Loans: Who Borrows and Who Defaults (GAO/HRD-90-33FS, Oct. 17, 1989)

Guaranteed Student Loans: Analysis of Student Default Rates at 7,800 Postsecondary Schools (GAO/HRD-89-63BR, July 5, 1989)

Defaulted Student Loans: Preliminary Analysis of Student Loan Borrowers and Defaulters (GAO/HRD-88-112BR, June 14, 1988)

GAO's Views on the Default Task Force's Recommendations for Reducing Default Costs in the Guaranteed Student Loan Program (GAO/T-HRD-88-7, Feb. 2, 1988)

Guaranteed Student Loans: Potential Default and Cost Reduction Options (GAO/HRD-88-52BR, Jan. 7, 1988)

Guaranteed Student Loans: Analysis of Insurance Premiums Charged by Guaranty Agencies (GAO/HRD-88-16BR, Oct. 7, 1987)

Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987)

Defaulted Student Loans: Private Lender Collection Efforts Often Inadequate (GAO/HRD-87-48, Aug. 20, 1987)

Defaulted Student Loans: Guaranty Agencies' Collection Practices and Procedures (GAO/HRD-86-114BR, July 17, 1986)

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PROFESSIONAL
ENGINEERING
& RESEARCH
CONSULTANTS

October 29, 1990

Fax: 202-224-1972
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Honorable Sam Nunn, Chairman
Senate Permanent Subcommittee on Investigations
100 Russell Senate Office Building
Washington, DC 20510

Senate Permanent Subcommittee
on Investigations
EXHIBIT # 43

Attention: Ms. Grace McPhearson

In conjunction with telephone communications with your office on September 26, October 5, and this day, I am pleased to submit testimony to your hearings on the student loan crisis, and specifically on the closure of the First Independent Trust Company in Sacramento which has created a tragedy for over 1,500 individuals, banks, retirement programs, etc.

I have reviewed the written testimony sent to me by your office and my testimony presents information and perspectives that were not included in the other written remarks. I am sorry that I was unable to attend the hearings in person and make myself available for questions from yourself and other members of the Senate and staff. However, I am willing to respond to any questions you may have concerning information I have gathered during my unfortunate experience with FITCO and the various public and private institutions involved.

I was in Washington October 16 through 20, but my schedule did not permit a visit to your office. I am completely involved (12 hours a day) in the development of two major national conferences on policy matters affecting the future of the nation. One is a national conference on Public/Private Partnerships in Transportation, being held on November 14 and 15, that will identify the policy changes needed if private capital is to flow into the transportation crisis. The second is a major national conference on science and technology policy called, "What if Peace?" being convened on November 28 and 29. Both of these conferences are sponsored by the California Engineering Foundation, of which, I am the president.

If I can be of further service to you on matters related to the student loan disaster or in other matters related to science and technology policy, please give me a call.

Sincerely,

Robert J. Kuntz, Sc.D.
President

913 K STREET MALL, SUITE A, SACRAMENTO, CA 95814, (916) 442-6369

Testimony to
The Senate Permanent Investigating Committee
United States Congress
FIRST INDEPENDENT TRUST COMPANY

THE TRUSTS AND TRUSTORS' INTERESTS

by: **Robert J. Kuntz, Sc.D.**
October 10, 1990

BACKGROUND

The First Independent Trust Company, a Sacramento, California, based firm, was the only private organization specifically chartered by the United States Government to provide opportunity for individuals to finance student loans. The unique character of FITCO permitted it to initiate an unlimited number of student loans through the management of individual trust accounts. FITCO was classified as an ***eligible lender*** under ***Title 20, Section 1085 (d)(1)(A) of the U.S. Education Code***. Under the Code, FITCO had to be certified by a Federal or State agency in order to qualify as a lender for student loans.

Unique in the nation, FITCO established individual trust accounts, executed by individuals, firms, investment organizations, schools, banks, retirement plans, limited partnerships, and others in which these entities were able to provide funds for student loans. All other student loan funds in the nation were provided by banks, savings and loan institutions, credit unions, international letter of credit banks, etc. in which there was no direct tie between the individuals providing the funds and the student. FITCO was the only trust company in the nation providing student loans, and the trustees the only such fund providers.

The Federal Government specified that the trustors were not permitted to manage their trusts independent of FITCO, since no other trust company met the statutory requirements established by the Congress with the sanction of the U.S. Department of Education. As such, the trustors were insulated by Federal Government action from any of the rules and regulations for maintaining the guarantees on the loans represented in their trusts or any of the "due diligence" requirements in the loan collection process, including loan origination and insurance fees.

Subsequent to the failure of FITCO, the U.S. Department of Education ruled that the trustors as individuals or collectively were not ***eligible lenders*** and withheld interest payments due the trustors on loans held in behalf of the trustors.

The relationship between the over 1,500 trustors and FITCO was that of trustor to trustee. The trustors directed FITCO to purchase student loans and designated FITCO as the exclusive Trustee for this purpose, in accord with referenced Title 20, Section 1085 (d)(1)(A) of the U.S. Education Code. It must be assumed that as in any other case, the Trustee and Trustors are bound by the agreement, in this case, specified Federal law and regulation, and the laws establishing the rights and responsibilities of trustees and trustors. Under no circumstances do trustors assume any liability for actions taken by a trustee, and trustors were so notified in printed documents provided them by FITCO.

In May, 1989, the California Department of Banking closed FITCO and confiscated all files and equipment. The Department desired to ***liquidate*** FITCO as though it were a banking institution. However, in this case, the trustors interest required an ongoing effort to provide trustee services to the trustors and disposition of numerous partially completed financial transactions with schools, students, and the secondary lenders, and resolution of deficiencies records.

At that time, the California Banking department had two possible directions that could be taken to resolve the trustors' interest. On the one hand, the trustors could have been considered non involved, innocent but effected, parties to a quagmire of deficiencies in the trust company, secondary lenders, the Banking Department itself, the U.S. Department of Education, the California Student Aid Commission, the State Department of Education, and the Higher Education Assistance Foundation. On the other hand, the trustors could be considered as the ***deep pocket*** to correct the financial deficiencies of all other parties.

Unfortunately, the Department of Banking chose the latter approach.

There is an old engineering phrase that says, "when all else fails, read the instructions.

THE GIVENS

1. FITCO was singular in its charter to initiate student loans and was one of the three largest initiators of student loans in the nation. The U.S. Department of Education was supportive of, and may even have initiated the House of Representatives' amendments in 1986 which inserted FITCO, by definition not name, into the U.S. Education Code. This action was taken after the Department of Education had over six years of experience dealing with FITCO'S, what is now known as, major deficiencies in operation.

2. The Federal Government had continuous interaction with FITCO for nearly 10 years during which time FITCO had initiated over $1 billion in student loans. Money flowed in both directions, i.e., FITCO would send checks to the Department of Education for loan initiation fees and insurance premiums, and the Department would send checks to FITCO for interest payments and initiator premium..

3. The process through which FITCO was able to initiate the large number of loans with a limited amount of funds provided by trustors was through the quick sale of initiated loans to secondary lenders, such as West Texas, Bank of America, CHELA, etc.

4. All loans were against specific trust accounts held by trustors and administered by FITCO and document in the FITCO accounting system, so each trustor could, theoretically, identify the particular loans represented by the trustor's funds at any time (theoretically - contingent upon the accuracy of the computer data base and posting system.) These records were constantly updated, since the trustor may have held the initiated student loan for only a day or week before it was sold to a secondary lender by FITCO, trustee.

5. The sale of a loan to a secondary lender resulted in the return of cash to the trustor's trust account which then permitted the initiation of another student loan. FITCO withheld funds received from secondary lenders for loan initiation fees from the trustors accounts, thus, such funds were never deposited in the trustors accounts but were held by FITCO for payment to the U.S. Department of Education. The specific student loan portfolio was then transferred to the secondary lender which assumed the full responsibility for collection.

6. The secondary lender ***assumed*** that FITCO paid the loan initiation fees and insurance premiums and that the notes purchased were guaranteed. The trustors had no contractual relationship with the secondary lenders nor were trustors permitted to be party to, or knowledgeable of, any transactions between FITCO and secondary lenders.

7. FITCO had contracts with secondary lenders to purchase a specific volume of loans.

8. Trustors were assured, in writing, by FITCO that their trusts had the highest guarantee of the Federal Government, equal to Treasury Notes and U.S. International Letters of Credit, and FITCO included in its literature that all trusts were backed by the "***full faith and credit of the United States Government.***" All FITCO brochures, prospectus, and other promotional material were subject to the scrutiny of the California Banking Department and the U.S. Department of Education in accord with the statutory requirements establishing FITCO as a qualified lender.

9. In order for FITCO to release funds for initiating Loans,

the following government actions had to take place:

a. The educational institution had to be certified by the California Department of Education.

b. The borrowing students had to be qualified by the educational institution and had to meet the requirements established by the U.S. Department of Education and the California Student Aid Commission.

10. FITCO trust accounts were considered to be advantageous to trustors over other savings instruments because they were backed by the full faith and credit of the United States Government, had liquidity, and permitted insured savings without the limits ($100,000) imposed on banks and savings and loan institution deposits by FDIC and FSLIC. Thus, trustors were guaranteed the highest federal protection for their funds with no limit on account size.

11. Trustors had the assurance that FITCO was certified to carry out the unique student loan initiation program through printed material available to the general public and under the regulatory oversight of state, federal, and federally sanctioned private institutions, and the knowledge that FITCO was continually monitored and inspected by the U.S. Department of Education, the California Student Assistance Commission, the California Department of Banks, and the Higher Education Assistance Foundation. Information was either not available to the trustors or intentionally withheld from them by the responsible government agencies, as to any deficiencies in FITCO'S operations. None of these public agencies ever took any action to lead FITCO trustors to believe that any problems existed in the student loan program or with FITCO as a uniquely chartered trustee to develop and manage trusts for trustors providing funds for student loans.

12. The California Banking Department informed a group of trustors in a post-shut down mass meeting that the Banking Department was prohibited by law to disclose the actual financial conditions of FITCO and refused to release records of prior audits under confidentiality limitations.

13. The California Department of Banks assumed, in fact, fiduciary responsibility as the trustee to act in the best interest of the trustors when it took over FITCO in May, 1989 and began the liquidation of FITCO.

14. Secondary lenders purchasing student loan instruments from FITCO had a fiduciary responsibility to assure themselves that FITCO was in fact transferring the loan initiation fees and insurance premiums to the U.S. Department of Education, and that responsibility is likened to a property owner having the responsibility for seeing that labor trades and other subcontractors are paid by the contractor under mechanics lean laws. The relationship was between the secondary lenders and FITCO not the trustors.

15. The California Department of Banking, in its continuous auditing responsibilities, certified FITCO as a acceptable depository for regular banking institution deposits, and upwards to five California banks, ensured by FDIC, were such depositors and held trust accounts.

16. The California Auditor General, in 1988, found the California Department of Education deficient in its certification process of qualified schools for students applying for student loans. Subsequently, the Department dropped certification of a number of schools private, proprietary, and public institutions.

SUMMARY

In the world of investments, there are many opportunities for individuals to deposit their funds. The common law differentiates between unsophisticated and sophisticated investors. Statutory and administrative law provides certain protections for unsophisticated investors and requires certain disclosures to even sophisticated investors.

FITCO trustors included both unsophisticated and sophisticated investors, and the trustors had every assurance that FITCO had the highest guarantee, as an institution, and the student loan program administered by FITCO had the highest U.S. government guarantee of any financial investment in the world. FITCO trustors had even greater assurance that their funds were ***backed by the full faith and credit of the United States Government*** than depositors in banks and savings and loan institutions. What assurance does a depositor in a bank and savings and loan institution have that the sign in the institutions that deposits are insured to $100,000 by FDIC or FSLIC? The assurance is that government agencies would not permit such institutions to post such a sign if it were not true. Yet, FITCO was overseen by at least five government and private (sanctioned by government) institutions, and all information available to all sophisticated and unsophisticated investors were assured the highest protection for their funds.

Now, all government and private entities are treating the FITCO trustors as though they have the lowest standing of any investors, even below that of individuals who purchased junk bonds in the failed Lincoln savings and loan institution.

The trustors are innocent parties in the quagmire between FITCO, NEAF, the U.S. Department of Education, the California Banking Department, the California Student Assistance Commission, the California Department of Education, Bank of America, West Texas, CHELA, and other entities. The trustors should be held harmless and made whole immediately so that

their trusts' assets and all interest due on them are returned as quickly as possible. Trustors' assets should not and cannot be treated as deep pocket resources to correct any claims against FITCO by any government or private entity. Trustors' assets should not be used to cover any costs associated with the liquidation of FITCO.

Since the U.S. Department of Education was ultimately responsible for establishing FITCO as the only trust company allowed to carry out the unique student loan initiation process, and the only entity in continuous interaction with FITCO, the U.S. Department of Education, acting in behalf of the U.S. as a whole, bears prime responsibility for extricating the FITCO trustors from the quagmire created by deficiencies, negligence, and in some cases, fraudulent behavior of government and private institutions.

The most expedient manner to accomplish this objective is for U.S. Department of Education to return all trustors' funds, with full accrued interest, to the trustors immediately and subsequently work with the California State Department of Banking, and all others to resolve the final accounting of who owes what to whom.

Note: The information presented herein has been obtained through conversations, meetings, research, printed material,and word of mouth. It is presented to increase understanding and does not represent any formal declarative position of the FITCO trustors. It does represent a general consensus of many of the affected trustors as reflected in the interactions that have taken place since FITCO'S operations ceased in May, 1989. Copies of printed reference materials are available upon request.

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on Investigations

EXHIBIT # 47

STATEMENT OF THE
NATIONAL COUNCIL OF HIGHER EDUCATION LOAN PROGRAMS
IN CONNECTION WITH HEARINGS
BY THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
UNITED STATES SENATE

The National Council of Higher Education Loan Programs, Inc. (NCHELP) is an organization representing the providers of federally Guaranteed Student Loans -- State and private nonprofit guaranty agencies, secondary markets, commercial lenders, loan servicers and collectors, and institutions of postsecondary education, The Guaranteed Student Loan (GSL) Program is second only to individual family contributions as the largest program of financial assistance for postsecondary education. Since its inception, it has provided almost 50 million loans, totalling more than $100 billion.

In FY 1979, GSL lenders made more than $4.8 billion available to 1.5 million borrowers. A decade later, more than $12.4 billion was loaned to 2.7 million individuals. This phenomenal growth has been accompanied by increasing default costs (reflecting the vastly increased amounts in repayment status), untenable default rates at some institutions of postsecondary education, and isolated but newsworthy examples of fraud and abuse.

As the GSL Program approaches its 25th anniversary, modifications need to be made to the statute to address today's concerns. To this end, on July 18, 1990, the NCHELP Board of Directors adopted a number of recommendations to be presented to the Subcommittee on Education, Arts, and Humanities of the Senate Committee on Labor and Human Resources as part of the reauthorization of the GSL Program in the next Congress. A number of those recommendations are relevant to the issues addressed in these hearings.

As a departure point, the Board endorsed the principle that **the foundation of financial assistance to low-income students should be grant aid.**

Research studies on GSL defaulters show that the major reason that students default on their loan obligations is that they do not have the money to make the necessary loan payments. Current GSL collection practices are highly sophisticated; we no longer have the stereotypical highly-paid doctor with a BMW who can successfully thumb his nose at attempts to collect his student loan. Almost all guaranty agencies participate in the IRS offset program, which offsets potential refunds owed taxpayers against student loan debt; so far this year nearly $223 million has been returned to the Treasury through this program. Many States have accompanying State tax offset laws. Guaranty agencies subrogate defaulted accounts of federal employees to the U.S. Department of Education for wage garnishment. Many guaranty agencies have agreements with State licensure agencies, which will deny professional or business licenses to applicants who are GSL defaulters; others have arrangements with Departments of Motor Vehicles for address checks of drivers' licenses. Agencies also use the most recent IRS data for most-current-address verification. And at least one State has the authority to capture lottery winnings to offset a defaulted student loan!

The inability -- as opposed to unwillingness -- of the large majority of defaulters to repay stems from a number of causes. As a result of the needs analysis requirements implemented in 1986, the GSL Program has experienced a substantial change in characteristics of students served. As a consequence, borrowing in the Stafford (subsidized) Loan Program has shifted progressively away from middle-income students who, statistically, could be expected in the past to have higher repayment rates. PLUS and SLS loan volumes have mushroomed, yet many middle-income parents do not qualify for PLUS loans, and SLS loans serve a disproportionate number of low-income student borrowers.

In addition, the GSL Program is the only federal student financial assistance program that provides support for courses of as little as 300 clock-hours (or their credit-hour "equivalent). Other programs (Pell Grants and the campus-based programs) require a course length of at least 600 clock-hours. However, institutions with 300 clock-hour programs often enroll the neediest students, who have the least expectation of obtaining the credentials necessary to escape a minimum-wage career and the highest likelihood of defaulting on their student loans.

It has become increasingly evident to NCHELP that student loans should be targeted on those who have demonstrated the capacity to progress through education programs leading to employment that provides an income sufficient to repay the loan, and to those for whom grant funds are not sufficient to cover the costs of education. For that reason, NCHELP recommends a basic restructuring of grant and loan programs to assure adequate grant funds up front in the educational process. The viability of the Guaranteed Student Loan Program would be greatly enhanced by targeting loan eligibility to those borrowers who have demonstrated not only financial need but also the capacity to progress through education programs which lead to a level of employment sufficient to enable the borrower to repay his or her loans.

The importance of access to postsecondary education for all Americans cannot be overstated. For millions of young students, beginning their lives as independent citizens, education is the only avenue of opportunity for improving their lives, and those of their families. New workers will find that occupations of the future require ever-increasing levels of education and training. However, in order to be productive, their education and training must be effective and of high quality. Access must be assured, but it must be access to an education which offers a positive outcome for the student.

Although the postsecondary sector at large offers adequate, and in many cases outstanding, programs, vagueness about educational standards has enabled some educational institutions to offer programs of questionable quality. In addition, lack of clear areas of responsibility among the various entities charged with determining institutional quality and eligibility to participate in the GSL Program has hampered program enforcement efforts. NCHELP recommends a number of changes in the area of institutional eligibility that it believes will provide a basis for participation which emphasizes educational effectiveness and consumer protection without arbitrarily excluding any sector of post-secondary education.

a. The definitions relating to institutional eligibility should be the same for all title IV programs. GSL length-of-program requirements should be altered to coincide with those of the Pell Grant and Campus-Based Programs (600 hours). Such a change would have positive benefits in the area of default reduction, since it would minimize the prospect of students relying exclusively on loans in order to finance their education. Furthermore, it would address the questionable recruiting practices of certain short-term vocational institutions with very high default rates.

b. For the purpose of demonstrating eligibility to participate in federal student financial aid programs, all institutions providing occupational, vocational, or technical training must measure such training in clock hours. This would put an end to the current instances of course-stretching through artificial conversion from clock hours to credit hours, thus creating additional GSL (and Pell) eligibility for borrowers enrolled in occupational, vocational, and technical training.

c. States must become more heavily involved in oversight activities of, and licensing requirements for, vocational postsecondary institutions. They must monitor the quality of education and perform consumer protection functions with regard to institutions they license. These functions should include, but not be limited to, monitoring advertising or placement claims and institutional refund policies. Evidence of accreditation should no longer be the sole basis for receiving a State license to operate.

d. Although the Secretary has no authority to regulate institutional curricula, he clearly has authority to provide consumer protection guidelines to safeguard the use of public student aid funds and subsidies. NCHELP recommends that stringent institutional eligibility standards be developed by the Secretary for institutions that wish to participate in student aid programs, including but not limited to:

- Mandating standards for state licensing criteria, which incorporate requirements relating to educational outcomes and consumer protection measures. Those standards must be met in order for state licensing to serve as a basis for federal student aid participation.

- Requiring educational institutions to demonstrate financial and administrative competency and integrity before participating in federal student aid programs and as a condition of continued eligibility.

e. In order for the Secretary to recognize accrediting associations as proxies for conferring eligibility for federal student aid funds, it is necessary that he exercise stringent control over the scope of accrediting practices related to conferring such eligibility. In addition, he must enforce minimum standards for review and oversight.

National and regional accrediting entities should be required:

- to incorporate stringent consumer protection standards as part of the accreditation requirements;
- to inform the Secretary of all actions taken with regard to schools;
- to have public support (financial and/or legal), where deemed appropriate by the Secretary, if sued by institutions for removal of accreditation; and
- to approve any new and/or branch site separately, and to provide for better oversight of branch campuses.

f. Any new institution wishing to participate in the Guaranteed Student Loan Program must establish a Default Management Program, as outlined in current regulations, for the first two years of such participation.

g. An institution which changes ownership or becomes a branch should also be subject to a Default Management Program for two years after change of ownership or status. In addition, guaranty agencies should have authority to regulate loan volume of such institutions.

h. In addition to participation in Default Management Plans, institutions with default rates over 20% must require their students to go directly to a lender to obtain a loan application. This requirement would preclude a high-default institution from forwarding completed student loan applications to lenders. Such forwarding can contribute to increased defaults, when students are unaware that they are actually obtaining loans rather than grants.

i. Any change in institutional ownership will trigger a new eligibility test for financial soundness and an examination of the new owner's record, as well as a check for previous program suspensions.

j. Institutional codes for GSL, Pell, and campus-based programs should be unified into a single code number. The Secretary must identify, through a separate code, all branch and subsidiary campuses.

k. All institutions must have an independent third-party compliance and financial audit performed biennially which certifies that federally mandated institution-wide standards are being met. Such audits shall be available to guaranty agencies, secondary markets, lenders, State licensure agencies, accrediting agencies, and the Secretary.

l. Strong measures should be taken to provide for consumer protection for all students by requiring the following:
   - Refund policies should be fair and prorated.
   - Institutions that advertise must prominently disclose in such advertisements their own experience with:
     - typical amounts borrowed;
     - placement rates;
     - completion rates;
     - salary offers; and
     - successful licensure of graduates.

m. A guaranty agency shall require a participation agreement with any institution served by the agency.

n. Limitation, Suspension, & Termination (L, S, & T) actions must be effective across agency lines immediately and the Secretary must be instructed that the word "disqualify" in section 432 may mean suspension or limitation -- not necessarily termination. The Secretary must act with due speed on agency L, S, & T actions; if he fails to overturn an agency's decision on procedural grounds within 60 days, that decision is automatically extended to all other guarantors.

o. Current prohibitions on the use of commissioned salespersons have apparently not curbed the incidence of abuses in recruiting students. Therefore, NCHELP proposes that institutions not be able to use commissioned employees in any phase of their operations, unless the sole basis of the commission is the graduation or placement of the student involved in the recruitment.

Current law provides for delayed disbursement of SLS Loans for first-year borrowers at high-default schools; Departmental regulations require similar delays in disbursement for first-time Stafford and SLS borrowers in schools with default rates of 30% or higher. NCHELP believes that these provisions should be monitored closely to ascertain whether they effectively reduce default rates and whether all requirements for delayed disbursement should ultimately be included in the Higher Education Act.

Current regulations apply a ratable refund policy to high-default institutions. NCHELP endorses a refund policy which mandates that title IV refunds by applied first to a student's outstanding indebtedness in SLS and Stafford loans. Such priorities benefit the borrower in the short run, by reducing his indebtedness, and the overall GSL Program in the long run by cutting default costs.

Correspondence education is almost impossible to monitor, and course length (which determines institutional eligibility) is difficult to verify. Costs of such programs are minimal, and all too often a Guaranteed Student Loan becomes a vehicle of basic student living support rather than assistance to defray educational costs. Therefore, NCHELP recommends that correspondence courses no longer be eligible for participation in the Guaranteed Student Loan Program.

In order to ensure appropriate targeting of loans and to ameliorate certain inequities in borrower eligibility, NCHELP offers the following recommendations:

a. No SLS Loans for first-year students. Current law restricts SLS borrowing by first-year students in high-default (more than 30% cohort rate) schools. As GAO has documented, this has substantially reduced SLS volume, especially in the proprietary sector. NCHELP believes that if sufficent grant funds are available, as recommended, all first-year SLS borrowing should be eliminated to avoid crippling debt burdens on borrowers who have not exhibited a level of persistence in pursuing their education.

b. Foreign nationals should no longer be eligible to borrow under the GSL Program. These individuals are often provided support by their home governments; they are difficult, if not impossible, to collect from when they return to their home country.

c. Currently, students without a high school diploma or a GED may be eligible for Stafford Loans. It is highly questionable whether it is prudent fiscally or socially to enable students to borrow who have not yet fully demonstrated minimum secondary education capacity. NCHELP recommends that no Ability-to-Benefit students should be eligible for the GSL Program.

d. Stafford, PLUS, and SLS Loans should be ratably reduced if the length of the program is less than one academic year, as defined by federal regulations. Only one maximum loan should be allowed for each period of attendance of eight consecutive months.

e. Under current law a student loses all title IV eligibility if he/she borrows in violation of annual loan limits. NCHELP suggests that the punishment for a borrowing violation is too harsh. The law should be changed to mandate that students must repay amounts owed if they inadvertently have over-borrowed or double-borrowed, before they can be eligible for additional student aid. This provision would obviously not apply to cases of documented fraudulent borrowing.

Both Chapter 13 and Chapter 11 of the Bankruptcy Code, as currently interpreted and applied, pose serious problems for the Guaranteed Student Loan Program. Chapter 13 contains no special provision preventing declaration of bankruptcy for the first 5 years of GSL repayment, as does Chapter 7. As a result, the federal government, as an unsecured creditor, often receives a few cents on the dollar under a Chapter 13 "workout" obviously designed to escape student loan debt. To avoid this abuse of the bankruptcy laws, NCHELP recommends that the current bankruptcy provisions be revised to assure that no borrower can use consumer-related bankruptcy provisions to discharge student loans.

Similarly, institutions seeking relief under Chapter 11 "workout" provisions have been held by most bankruptcy courts to have sufficient property rights to title IV student financial assistance that neither the guaranty agency nor the Department of Education is allowed to terminate the flow of student aid funds to the institution during the pendency of Chapter 11. Since many institutions seek bankruptcy protection when threatened with L, S, & T actions for severe program violations, court decisions have the effect of requiring lenders and the federal government to "throw good money after bad," with the virtual certainty that it will never be recoverable. NCHELP recommends that the Bankruptcy Code be amended to allow for the cut-off of student aid funds to an institution in Chapter 11, when circumstances external to the bankruptcy warrant taking such action. In addition, the Higher Education Act should be amended to make it clear that student assistance funds are what their name implies -- aid to the student and not a property right in the institution.

Administrators of bankrupt institutions (in both Chapter 11 and Chapter 7) should be given an affirmative duty immediately to pay in full all refunds owed to students, lenders, and guaranty agencies, without awaiting proofs of claim. (The refund money does not belong to the institution. It should be used neither for institutional administration nor for distribution to creditors of the institution.)

Current default problems most often stem from an absence of positive educational outcomes rather than from an absence of lender and guaranty agency due diligence. The failure to take these facts into consideration has produced a regulatory straightjacket, causing unwarranted losses to lenders, servicers, secondary markets, and guaranty agencies.

Adequate incentives for lenders to continue to provide capital for Guaranteed Student Loan Programs must be maintained. It must be remembered that, although the loan programs cost the federal government approximately $3.5 billion last year, that investment translated not only into providing $13 billion worth of student financial assistance (through loan programs alone) but also into covering costs of default, death, disability, and bankruptcy for more than $50 billion of loans in repayment. The federal government cannot, and need not, provide this level of loan capital out of budget revenues to support the continuation of the various loan programs.

The federal government's interest insofar as lenders and guarantors are concerned ought to be the delivery of financial assistance to students in the most efficient manner possible, and at the least cost to the government. Accordingly, policies governing guaranty agencies in the administration of federal student loan programs should focus on providing incentives for efficiencies in program operations and rewards for default reduction initiatives, rather than penalties for noncompliance violations of regulatory minutiae.

NCHELP believes that the concepts underlying the Guaranteed Student Loan Program are fundamentally sound; the Program is essential to the financing of postsecondary education and to promoting educational choice. We appreciate the Subcommittee's offering the Council the opportunity to share its recommendations for the Program's improvement.

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Senate Permanent Subcommittee
on Investigations

EXHIBIT # 48

STUDENT LOAN MARKETING ASSOCIATION
1050 Thomas Jefferson Street, N.W.
Washington, D.C. 20007
202-298-2600

LAWRENCE A. HOUGH
President and
Chief Executive Officer

September 20, 1990

The Honorable Sam Nunn
Chairman, Permanent Subcommittee
On Investments
United State Senate
303 Senate Dirksen Office Building
Washington, DC 20510-1001

Dear Senator Nunn:

The Student Loan Marketing Association is pleased to have this opportunity to submit a written statement to the Committee as part of its examination of the federal Guaranteed Student Loan Program. We believe that we can be most helpful to the Committee by commenting from the perspective of a secondary market and by limiting ourselves to issues that are directly apparent from our own particular vantage point. Other program participants such as loan originators, guarantee agencies, schools, students, and the Education Department will undoubtedly comment on some of the basic policy issues being considered by this committee.

Sallie Mae is a federally chartered, stockholder-owned corporation which provides the nation's largest single source of financing for postsecondary education. Sallie Mae was created by the Congress in the Education Amendments of 1972. To foster our public mission, assuring the availability nationwide of education credit, Sallie Mae is expected to provide leadership in the education credit markets to ensure the continuation of private capital availability for student loans. We also serve the interest of our investors--commercial lending institutions, educational institutions, and the general public; it is their continued confidence--and investment--in Sallie Mae that enables us to accomplish our mission. In carrying out that business mission, our shareholders expect us to achieve a reasonable return on investment and not to assume risks which would adversely affect our ability to do so.

Since 1972, Sallie Mae has provided over $50 billion in funds and commitments for educational loans; this represents funding for more than 20 million student loans. Today the corporation, both by buying student loans and by providing collateralized warehousing loans to lenders to finance student loans they own, funds about four in ten of all student loans outstanding.

Limiting Fraud and Abuse

Fraud and abuse in the GSLP is most likely to occur at the time of loan origination. It is then that schools may misrepresent the quality of their educational program or the employment prospects of its graduates, that schools or lenders may mismanage student loan funds or inappropriately withhold such funds from borrowers, that under-qualified students may be enrolled for study, or that schemes involving the creation of "fictitious" borrowers can be perpetrated. Secondary markets are the end of the loan pipeline; typically, when we acquire a student loan, the borrower has already completed his or her education and concluded contacts with the many other players in the student loan process. Since this is so, when we as a secondary market purchase a loan, we must necessarily rely on the safeguards built into the system. We must rely on the guarantee agency's decision to guarantee the loan as evidence that the loan is valid and was properly originated. We must rely on the fact that the educational institution has been approved as an "Eligible Institution" under all applicable federal, state, and local standards. We must also rely on the warranties and representations that are made to us by the qualified "Eligible Lender" that in making and servicing the loan it has complied with all program requirements. Secondary markets are designed to support underlying loan programs and while they can take steps to bring some discipline to the marketplace, they are not in a position to take direct action to prevent fraud and abuse by program participants.

Notwithstanding the foregoing, secondary markets must take steps to protect themselves, their shareholders, and their creditors from program compliance failures that occur at the time of loan origination. As part of its loan purchase program, Sallie Mae has maintained a set of loan acquisition guidelines that are designed to screen loans offered for purchase and filter out those loans that do not exhibit compliance with origination or servicing rules. Among the minimum standards Sallie Mae sets for purchased loans are: 1) the loan application must be complete and be signed by the borrower; 2) the loan must be made for an amount within statutory limits; 3) the loan must be approved by the guarantor; and 4) the loan must be fully disbursed. Sallie Mae also performs assessments of the financial condition of loan sellers, including reviewing the nature of the institution's lending activity and its customer base and, in some large-scale transactions, assessing the administrative capabilities of the selling lender. Sallie Mae purchase contracts routinely provide the corporation with recourse against the selling lender in the event that Sallie Mae discovers that the loan was not properly made or serviced prior to Sallie Mae's purchase or that the seller misrepresented the loan's characteristics at the time of sale. We believe that by exercising caution in our loan purchase practices and by providing such contractual safeguards, Sallie Mae encourages lenders to exercise care in their loan origination activities so that their loans will be eligible for purchase. We believe our practices also serve to dampen the possibilities for fraud and abuse.

The only real opportunities for fraud or abuse at the secondary market level are in regard to the submission of interest billings to the federal government or the falsification of collections records or borrower accounts. In Sallie Mae's case we have a strong Internal Audit Department that reports to our Board of Directors, whose assignment among other things, is to review servicing practices and procedures designed to guard against the occurrence of any such improprieties either at our own servicing center or at contract servicers. We also provide for annual review by our outside auditors. In addition our activities are subject to oversight by the U.S. Department of Education, the Comptroller General, and the various guarantee agencies through their program review and audit functions.

In attempting to manage risk in the purchase of student loans, Sallie Mae is mindful of the need to strike a balance between assuring itself that it is acquiring properly originated and serviced student loan assets and its mission to provide national liquidity for lenders extending credit to students and parents. As Sallie Mae strives to make its services available to the widest range of lenders, it is aware that its presence in the marketplace may encourage over-zealous lending practices on the part of certain banks who assume that they will have a place to sell their loans regardless of the nature of the borrowers or schools who are their customers. While we carefully attempt to verify the bona fides of our bank customers, we are not in a position to exclude loans from purchase based on our own assessment of the educational quality of the schools attended by the loan borrowers. This, we believe, is more properly a function of government in determining program participation.

Reducing Loan Defaults

There is little dissent in the student loan industry that something must be done to reduce the incidence of loan default. Loan defaults are not only costly to the U.S. Treasury, but to program lenders as well. When a loan defaults, lenders must undertake expensive collection procedures to ensure that the claim will be paid by the guarantor. Income that the loan holder expected to receive on that loan throughout the repayment period is also lost. We all have a stake in stemming program defaults.

Reducing loan defaults is not an easy task and is inextricably connected to issues that the Congress has wrestled with in the past and will be considering as part of the coming reauthorization of the Higher Education Act. These issues include establishing an appropriate mix between loans and grants, adopting postsecondary entrance standards (e.g., high school diploma or equivalent) for eligible borrowers, evaluating the desirability of universal loan access, determining whether a school's loan default rate alone is sufficient grounds for denying their students all forms of federal student aid, and the effect of changes in the loan program on the access of aspiring students' to postsecondary education. Only through full consideration of these issues can the Congress arrive at a national policy that can effectively reduce loan defaults while ensuring that deserving students are afforded the ability to pursue postsecondary educations and prepare themselves to be the productive citizens of tomorrow.

Sallie Mae does not believe that meaningful reductions in the incidence of default can be achieved through the imposition of additional collection requirements on program lenders. This is perhaps the most over-regulated aspect of the student loan industry. Regulations promulgated by the U.S. Department of Education and reinforced by the various guarantee agencies prescribe rigid sets of actions that must be adhered to in the collection of Guaranteed Student Loans. We are of the opinion that the current collection rules and accompanying penalties may be too uncompromising and that, in some aspects, they may be counterproductive. By forcing lenders to devote all of their energies to adhering to rote collection routines, such rules stifle innovative approaches to loan collection and the individual treatment of borrower circumstances. Measures which provide lenders with flexibility in designing collection methods could lead to improved collection rates.

Given the numerous program requirements imposed on students and lenders in recent years by the Congress and the U.S. Department of Education and the relative stability in the default rate over the last few years, it may be time to realistically assess just how effective additional collection requirements can be in reducing loan default rates. There is mounting evidence that most of the borrowers who default on their GSLP obligations are not purposefully attempting to avoid their repayment responsibilities, but are unable to repay their loans due to their financial circumstances. The February 1988 final report of the Belmont Task Force, assembled by Rep. Pat Williams, pointed to a "structural" default problem that could not be overcome by increased due diligence on the part of lenders. In the words of the report:

> Contrary to popular perception, the typical defaulter is not a "deadbeat" who refuses to pay, but appears to be a dropout who is unable to pay. Defaulters tend to be first year students, from low income and minority backgrounds, with a small loan balance who did not complete much more than the first year..., are likely to be unemployed when the loan comes due, and never make a first payment. The present default problem is thus predominantly structural. These costs are not likely to be recovered under the current terms of the program.

The Belmont report's conclusions are supported by virtually every study of loan defaulters. For example, a 1984 study by the New York State Higher Education Services Corporation found that two-thirds of borrowers who defaulted on their loans were unemployed. A June 1990 report, based on a 1988 survey of student loan borrowers by the U.S. Department of Education's National Center for Education Statistics, reported that student loan defaulters were earning less than one-half of the amount earned by borrowers currently repaying their loans; that the family incomes of loan defaulters were significantly lower at the time they received their first loan than the family incomes of borrowers who were repaying their loans; and that one-half of the defaulters had not earned a degree or certificate.

In light of these findings, there is reason to believe that, despite the most diligent efforts of lenders in servicing student loans, there will always be a certain proportion of loans that will not be repaid. Students whose investment in education does not adequately pay off in employment and earnings opportunities will be unable to meet their loan obligations and the best attempts at loan collection will never be able to prevent their eventual default. There is no doubt, too, that, while the default rate is no longer rising, the dollar volume of defaults will continue to rise as the volume of loans made increases and more and more needy students come to rely on the GSLP as a key source of funds for financing their postsecondary pursuits.

Role of Trade Schools in the GSLP

Sallie Mae is concerned, as are others, that certain practices and abuses within the proprietary sector of postsecondary education will threaten the health of the student loan and other financial aid programs. We agree with the Secretary of Education, numerous members of Congress, and many leaders of American higher education, that the system for accrediting for-profit trade and technical schools is in need of reform. We urge Congress and the U.S. Department of Education to explore the issue of whether the accreditation mechanism for assuring the quality of education provided by non-profit institutions of higher education is suitable for assuring the quality of education provided by trade schools. In the process of the accreditation of trade schools and the approval of their participation in the Title IV student financial assistance programs, there may be too much reliance on state or industry-supported groups that are not adequately assessing the administrative capabilities of the schools or the educational effectiveness of their training programs.

In examining the trade school question, Congress and the Department of Education also need to consider to what extent loans are an appropriate form of financial assistance for students engaged in such programs. One question that needs to be addressed is whether student loans should be made available only to students in training programs that achieve high completion and placement rates or provide borrowers with post-graduate earnings that are sufficient to repay student loans. Congress may also wish to consider whether the federal government should simply acknowledge the risk in its investment in training programs and be prepared to accept the inevitability that a significant percentage of loan defaults will ensue.

Relationships Between Lenders and Schools

In the course of examinations of abuses in the Guaranteed Student Loan Program, such as the one conducted by this Committee, there are often revelations regarding the close relationships between certain lenders and schools and the opportunities these relationships create for fraudulent practices. It is Sallie Mae's belief that a certain "arms length" between program lenders and participating schools is desirable. We believe that when lenders are independent from schools, they are more likely to exercise a form of checks and balances on the loan program by spotting improper practices on the part of schools. From some of the examples brought before this Committee in its hearings last week and earlier this year, it would seem that a school might have an easier time falsifying loan applications if it could depend on a lender to routinely accept applications without any screening process.

Congress has historically supported this "arms length" approach to lender and school relationships. The Higher Education Act includes provisions that provide restrictions on schools that wish to act as GSLP lenders. Home-study schools are specifically prohibited from acting as lenders, and other schools cannot make loans to more than one-half of their undergraduate borrowers and only can lend to undergraduates if those borrowers cannot obtain loans elsewhere. In 1986, Congress amended the Higher Education Act to prohibit GSLP lenders and guarantors from providing improper "inducements" to schools which are designed to direct student borrowers to certain lenders.

Congress has also discouraged banks from concentrating their activities on student lending. The Higher Education Act forbids eligible lenders from holding more than 50 percent of their loan portfolio in the form of student loans. While some have questioned the utility of this rule and have proposed that it be abandoned, we tend to believe that banks that are dedicated solely to the pursuit of student loan business and who must rely on such loans to support themselves are more likely to create relationships with schools that would have a detrimental effect on the loan program by promoting unnecessary and inappropriate borrowing.

Concluding Comments

Sallie Mae is pleased that your Committee has taken the time to explore evidence of misconduct within the Guaranteed Student Loan Program. We believe that all program participants are best served when those who would consider defrauding the government are put on notice that such actions will not be tolerated and that such activity will be severely punished. Schools, lenders, students, guarantors, secondary markets, and all other program participants have a stake in ensuring that the taxpayers who support the GSLP get their money's worth from the loans made under the program and that the nation as a whole is rewarded for its commitment to providing the means for aspiring students to benefit from postsecondary educational opportunities.

Given the large volume of loans Sallie Mae owns and services, it is surprising that we have received only a small number of allegations of serious improprieties by schools and lenders involving loans we have acquired. This leaves us to believe that fraud and abuse need not be accepted as a significant by-product of the student loan programs. We believe that the over $100 billion in loans made under the GSLP have been a worthwhile investment in human capital and that the program continues to serve an important national purpose.

Sincerely,

Lawrence A. Hough

Lawrence A. Hough
President and
Chief Executive Officer